Bad debt CFI & RFI response
January 2021

Summary response

We are pleased to have the opportunity to provide data and share our views on Ofwat's initial thinking around Covid-19 bad debt recovery.

In previous responses to consultations relating to the crisis, we have stressed that the issue of bad debt recovery is a priority concern for Everflow Water, and relayed our view that specific details of the regulatory response would need to be established before the full scale of Covid-19 related bad debt is known, to improve lender confidence. Now that we find ourselves in a third national lockdown, which is likely to be similar to the first, the uncertainty around the full scale of bad debt has been further extended. The economic impact of the pandemic is likely to extend beyond 2021, and it will be some time before we can say bad debt has crystallized. We are reassured by recent indications that Ofwat recognises the need for greater certainty about how bad debt will be recovered, and that it is seeking to deliver this within the coming few months. We would like to add that our desire for increased certainty does not mean that we are seeking the fastest possible remedy. It is important that the right action is taken, guided by the right objectives.

A key concern that we would like to highlight at this stage, is that what appears to be the current preferred option for a debt recovery mechanism – a one year increase to the REC price cap – would in our view be anti-competitive. This is because in reality we are effectively operating in two markets: a regulated market subject to the REC, and a competitive market where customers have entered into contracts with a retailer they have chosen. Delivering a price increase on the REC would protect the former to the detriment of the part of the market which is functioning more as a competitive market. Our answers to question 7 and 8 explain why we take this view. Our responses to the subsequent questions discuss the relative merits of four options, which we would rank in the following order:

1. Our preferred option is a REC price increase, but spread over a minimum of 3 years for alignment of the part of the market which is subject to REC terms with the part of the market which is functioning more as a competitive market.
2. Our second choice would be a hybrid option – based on the idea of recovering excess bad debt through wholesale charges, but replacing the need to involve wholesalers with the use of an independent administrator (such as MOSL).
3. Our third choice would be to recover bad debt through wholesale charges (including the bad debt of contracted customers along with deemed customers).
4. We oppose the option of a one year or 18 month increase to the REC, as we think this would be anti-competitive.

Our CFI response is accompanied by an updated picture on our bad debt position, through the RFI data provided. This demonstrates that the likely scale of excess bad debt is huge, and we fully expect that this will exceed 2%. We would like to emphasise a final key point, which is that the definition of Covid-19 bad debt needs to be clearly defined on the basis of well-established international accounting practices.

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?

Our view is that the exceptional costs to include are debt which is not recovered as a result of Covid-19, and interest costs relating to working capital which was required purely as a result of payment deferrals, difficulties and bad debt arising from Covid-19.

While costs relating to non-recovery of debt are the most significant item within bad debt costs [redacted], our interest costs arising from Covid-19 currently total [redacted] Given the timescales over which bad debt costs will be recovered are indicated as being at least 2 years from March 2021, the additional interest costs could increase substantially given the borrowing required to replace the lost liquidity from aged debt increases and bad debt costs, [redacted].

Our calculation is based on:

- [redacted] additional aged debt that we have experienced
- An effective interest rate of [redacted] (which is our current borrowing rate, not the rate we expect to be able to borrow at given the lack of lender confidence in the market and inability to borrow through the government CBILS scheme)
- Assuming no recovery in 2021-22 and a straight-line recovery in 2022-23, which is Ofwat's current suggested method

Our external debt recovery costs for the 9 months from April to December 2020 were [redacted], and we also recruited extra staff into our collections team to respond to the increased volumes arising from Covid-19, with an annual cost of circa [redacted]. We anticipate that external costs will continue to increase over the next year since engaging with customers remains difficult in the current economic climate, and that unfortunately site visits are a more effective means of engaging with certain cohorts of customer.

It is clear from this that the impact of the pandemic is not just that there is an increase in aged debt and bad debt, but that even where retailers are collecting cash, the cost of doing so has increased significantly as a result of a reduction in customer engagement, particularly at the early stages of the collections journey.

We acknowledge Ofwat's view that retailers should manage these debt recovery costs as a normal part of our commercial activities. However, we would urge Ofwat to ensure that incurring these costs as a necessary part of recovering debt during the coming months and years is taken into consideration when setting the share of bad debt between retailers and customers.

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

Our experience to date has been that those industries impacted by Covid-19 most significantly, particularly those in the hospitality sector, are those who are struggling to or refusing to pay, and where engagement is most difficult. We have not provided any data on this due to:

1. Limitations with our data around industry segmentation
2. Acknowledgement that others in the industry are well-placed to share this
3. We do not believe this is a controversial or difficult viewpoint to substantiate from the wider press and frequent industry surveys (for an example, see https://www.bbc.co.uk/news/business-55313752)

Below we have shared some data by customer size and wholesaler region based on the debtors' ledger at 29 February 2020, and again at 19 January 2021, to show the proportion of aged debt and customers who are overdue at each point in time. This indicates if there has been any positive or negative movement in the groupings, to show if bad debt costs are worse in any particular area or with a group of customers.

Analysis by customer size (by consumption group)

	Feb 20		Jan 2021	
Bandings	**% of aged debt value**	**% of overdue customers**	**% of aged debt value**	**% of overdue customers**
>50Ml	3.3%	0.2%	5.5%	0.2%
0.5-50Ml	67.6%	28.8%	64.8%	28.6%
0.5Ml	29.1%	71.0%	29.8%	71.2%

The data shows some small variances; particularly an increase in the larger customer segment, which is due to one or two larger customers where we are experiencing significant creditor stretch due to Covid impacts. However, the change from pre-Covid levels both in value and volume of customer arrears supports the view that customers have been equally impacted across volume segments.

We would highlight to Ofwat at this point that as our customer base is SME-focussed, that we are not in a position where we can recover material costs from our largest customers, both because we do not have many, and because the impact is predominantly being felt in the SME space.

Analysis by customer region

As we are in a unique position to provide evidence to Ofwat on regional differences, given that we are the only retailer to operate across whole of market within the SME space, and to have customers spread evenly across all wholesaler regions based on size of wholesaler, we have completed a full analysis of the regional impact of the crisis.

We have not found that there is a significant difference in our exposure to bad debt costs based on size of customer and/or geographic region. We therefore do not consider that there is any evidence to support a weighting of support based on region or customer size.

Our data below shows the spread of our customers based on region:

Wholesaler	Share of total customers
AFFINITY-W	4.3%
ANGLIAN-W	7.7%
BRISTOL-W	1.6%
NORTHUM-W	6.7%

PORTSMOUTH-W	0.8%
SEVERN-W	14.1%
SOUTHEAST-W	4.0%
SOUTHERN-W	3.9%
SOUTHSTAFF-W	2.3%
SOUTHWEST-W	3.2%
SUTTON-W	0.6%
THAMES-W	12.0%
UNITED-W	16.0%
WESSEX-W	1.9%
YORKSHIRE-W	8.4%
Grand Total	**100.0%**

Debt by wholesaler region:

	Feb-20		**Jan-21**	
Wholesalers	**% of aged debt value**	**% of overdue customers**	**% of aged debt value**	**% of overdue customers**
AFFINITY-W	4.2%	4.6%	4.8%	5.0%
ANGLIAN-W	7.7%	7.8%	5.7%	7.3%
BRISTOL-W	0.7%	1.5%	1.1%	1.5%
NORTHUM-W	7.7%	9.0%	9.6%	8.5%
PORTSMOUTH-W	1.0%	0.7%	1.1%	0.8%
SEVERN-W	9.9%	13.8%	15.9%	14.7%
SOUTHEAST-W	4.0%	2.4%	2.8%	2.7%
SOUTHERN-W	5.8%	4.4%	4.0%	4.5%
SOUTHSTAFF-W	2.7%	3.9%	3.7%	3.5%
SOUTHWEST-W	1.9%	3.1%	2.4%	3.0%
SUTTON-W	0.4%	0.7%	0.5%	0.6%
THAMES-W	16.2%	15.5%	15.0%	17.2%
UNITED-W	29.1%	18.8%	23.2%	18.2%
WESSEX-W	1.7%	1.8%	2.5%	1.9%
YORKSHIRE-W	6.9%	12.1%	7.8%	10.5%

From the table above, we can see that whilst there are some variances on the value of debt [redacted], the proportion of customers who are overdue by region has not changed materially. There are some movements, such as the Severn Trent and Thames areas increasing by 0.9% and 1.7% of our total customers in debt, and the Yorkshire region decreasing by 1.6%, but there is nothing to indicate a material shift in exposure by region.

When comparing this data to our share of customers in each region, we note that there is not a material variance to indicate that one region should receive preferable treatment due to customers being more significantly impacted in that region.

We also provide information based on direct debit cancellations by region since 16 March to the current date, the point at which we identified the beginning of a spike in cancellations:

Wholesaler	**DD cancellations**	**Percentage of cancellations**	**Total customer volumes**
UNITED-W	[redacted]	17.4%	16.0%
THAMES-W	[redacted]	16.1%	12.0%
SEVERN-W	[redacted]	14.5%	14.1%
YORKSHIRE-W	[redacted]	11.0%	8.4%
NORTHUM-W	[redacted]	8.3%	6.7%
ANGLIAN-W	[redacted]	7.5%	7.7%
SOUTHERN-W	[redacted]	4.5%	3.9%
AFFINITY-W	[redacted]	4.4%	4.3%
SOUTHWEST-W	[redacted]	4.3%	3.2%
SOUTHEAST-W	[redacted]	3.5%	4.0%
WESSEX-W	[redacted]	2.7%	1.9%
SOUTHSTAFF-W	[redacted]	2.4%	2.3%
BRISTOL-W	[redacted]	1.6%	1.6%
PORTSMOUTH-W	[redacted]	0.9%	0.8%
SUTTON-W	[redacted]	0.7%	0.6%

When this data is compared to the spread of our customers across the regions in order to identify whether more of the cancellations were in a particular region than expected, the data indicates there are some slightly larger variations in areas such as Thames (4.1% higher), Northumbrian (1.6% higher) and Yorkshire (2.6% lower). However, this fits with the small increases in aged debt volumes and values, and the aged debt figures do not indicate that the cancellations fully converted to aged debt and therefore bad debt costs.

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

Question 4 – Do you agree that Ofwat should allow Retailers to determine the basis on which they report bad debt costs (provided that it complies with relevant accounting standards)? Alternatively, should Ofwat set out a more prescriptive and defined basis for the determination and reporting of bad debt costs? Please set out the basis for your view or conclusions.

We would like to highlight that under standard accounting practices, the definition of Covid-19 bad debt would not usually be constrained to debt which arises from costs that became due within a particular timeframe. Under IFRS 9 and FRS 102 bad debt is recognised when there is evidence that a customer or group of customers will not pay, based on when that evidence arose, rather than relating to when the service was provided. The recognition in both cases is based on observable data that future cash flows recovered from outstanding debt is lower than previously expected. IFRS 9 was specifically brought in by the International Accounting Standards Board in response to the 2008 financial crisis, aimed at improving the accounting and reporting of financial assets such as trade receivables so that companies' balance sheets better reflected the risk of non-payment of debtors, rather than waiting until a write-off had been released, which historically resulted in a "too little, too late" approach to provisions.

We do not see why anything other than well-established accounting standards should be used to define bad debt costs (whether IFRS 9 or FRS 102), where bad debt is recognised when there is evidence that a customer or group of customers will not pay, based on when that evidence arose rather than relating to when the service was provided. The recognition in both cases is based on observable data that future cash flows recovered from outstanding debt is lower than previously expected.

IFRS 9 uses an 'expected loss calculation' which can be put simply as being the probability that a particular customer or segment of customers will default, multiplied by the loss that would be expected if the company defaults (in most cases, being the amount currently outstanding).

The Covid-19 pandemic is a significant event which has triggered the increase in bad debt provisions on company balance sheets, as this was the event that both increased the ***probability*** of customer defaults, and the level of debt outstanding with retailers.

In practice, the application of a statutory accounting practice to Covid-19 bad debt in the water retail market would mean the following:

1. Debts which relate to customer usage and service prior to January 2020 would not be excluded from the definition of Covid-19 related bad debt. As long as an appropriate calculation was undertaken prior to March 2020 for all debts outstanding at that point, any movement between this benchmark and the provision at March 2020 can reasonably be attributed to Covid-19 – the key change between pre-March 2020 and post-March 2020 is the ***probability of default***, which increased across the board as a result of the pandemic, and therefore bad debt levels increased.
2. Bad debt costs would be defined by when the evidence occurs, and refined over time, rather than retrospectively defined after the loss is finally crystalised – which could take several years.
3. In addition to determining the 'start point', bad debt provisioning also tracks when levels are returning to 'normal' – that is, the level which existed before the 'event' which created excess bad debt. This serves as a means for identifying when excess Covid-19 bad debt is no longer being incurred – which is likely to only become clear some years into the future. The government has provided an unprecedented amount of support to businesses, and as this is withdrawn, it is likely that some businesses will fail. Therefore some form of 'true ups' on bad debt recovery should be applied for some years to come.

In summary, provision calculations take account of past performance and current indicators in assessing the likely scale of bad debt. Given the likely timescales for bad debt crystallising, we feel this is the most appropriate method for calculating the likely scale of costs based on observable trends and past evidence of outcomes of aged debt and similar indicators, as a basis for intervention.

Given the level of standardisation that already exists in the market, and in line with Ofwat's principles that interventions should be efficient, low cost and simple, we further suggest that:

4. Existing independent assessment mechanisms should be used for the purposes of validating retailers' calculations of bad debt. Using widely accepted accounting standards, the levels of provision can be independently verified through a combination of statutory audits and additional assurance engagements where necessary (for example, to establish a pre-Covid benchmark at December 2019). Applying a different method would require independent assurance on a less-well understood definition and would not be as efficient

as leveraging the statutory audits which are already undertaken; thus increasing costs for retailers and customers.

5. Existing processes should be used as a basis for accounting for bad debt. Retailers already have appropriate processes and systems in place to handle the accounting basis. A new basis would require new processes and changes to systems which adds complexity and cost at a time when retailers are already stretched due to the pandemic.
6. Use of the statutory accounting basis also involves the assessment of whether previous accounting estimates were reasonable based on actual outcomes. To protect customers from overstated provisions which recover more than was ultimately suffered, audits in future years could include a review of the evidence of under- or over-provision.

Our year end is December, so we have been audited up to end of December 2019. We would assert that this presents an appropriate pre-Covid baseline on which to base our assessment of Covid-related bad debt costs.

As highlighted in point 6 above, due to the fact that reporting bad debt costs under accounting standards would involve the identification of overestimates, the risk of retailers misstating or overestimating their bad debt costs in a particular period will come through in a true-up the following period. If the approach taken involves a longer period of time over which to make the estimates, and therefore the recovery of charges occurs over a number of years (as suggested in our response to Q8), then the impact of overestimating on customers is minimised and recoveries in later years would then be reduced accordingly.

The statutory audit process by its nature is also sufficient to identify any material misstatements which would be significant enough to be a concern to Ofwat or would have a material impact on customers.

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

(a) We agree that bad debt costs arising should be measured from Jan 2020. However, as highlighted in our responses to Q3 and Q4, we do not believe it is appropriate to exclude costs relating to bills from 2019 and earlier for reasons set out in responses to those questions.

We would highlight that the baseline level of bad debt provision which is used as a starting point for measuring Covid-related bad debt cannot be March 2020, because at 31 March 2020 bad debt provisions would correctly include an initial assessment of the expected losses arising from Covid-related bad debt. We would propose a baseline of 1 January 2020 as the start of the calendar year for the following reasons:

1. The start of the calendar year provides a helpful starting point
2. A number of retailers use December as a year end, either for statutory purposes or in reporting to group companies
3. Any initial impacts felt by the pandemic in January or February will be captured in this period
4. If the level of Covid-related debt during these early months is lower than the 2% threshold, this will not impact on calculations and can reasonably be excluded.

We also disagree with Ofwat's "present view 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." (p. 15) Customers have been able to access unmatched levels of support during the coronavirus crisis by comparison with other economic crises, both from government and from other sources, including the water industry. We expect that as we move out of the crisis and as businesses lose this support, there will be some who cannot survive the harder economic environment post-coronavirus. In reality this depends on the economic recovery, but we think a substantial proportion of bad debt arising from the crisis will materialise as the support businesses are receiving is withdrawn. See our answer to question 12 on 'ending' the measurement and recovery of COVID-19 bad debt.

(b) Ofwat considers that there will be a further period of 6 months after bad debt costs arise before the true extent of bad debt becomes clear – which we agree with. We understand Ofwat to be saying that the earliest time at which bad debt will crystallize would be autumn 2021 – which we disagree with on the basis that we fully expect that bad debt costs will still be arising in autumn 2021. We believe that the period for measuring bad debt costs may extend out to the end of 2022/23, given the scale of the economic crisis and the uncertainty which exists within the economy. We also believe that there is no easy way to determine which businesses have received and utilised government support but will ultimately be unable to service this extra debt and will subsequently fail, which may take years to occur but will be no less related to the pandemic. Specifically, interest only begins to be repaid on CBILS loans 12 months after the loan was initially drawn, and therefore this may be the trigger for further defaults and 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.

Based on the evidence provided below, our current expectation is that bad debt costs (in this case purely defined as non-recovered debts) will increase from [redacted] of revenue prior to Covid-19 to [redacted] of revenue since March 2020.

Our view is that we expect bad debt costs to significantly increase, as indicated in our response to Q1. Bad debt is crystallised when Collection and Recovery routes are exhausted both from internal activities and through Debt Partner activities, as well as from customer insolvencies.

The data submitted within our RFI all points towards the scale of bad debt being significant, and well in excess of the 2% threshold that Ofwat has set out:

- The value of aged debt within the business has increased from [redacted] at 29 Feb '20 to [redacted] at 19 Jan '21.
- The percentage of customers on direct debit has decreased from [redacted] to [redacted] as a result of customers cancelling direct debits and ceasing to make regular payments.
- The value of debt sat with external debt collection agencies and in legal proceedings, where we know from internal data that our cash collection rate sits at [redacted] (see Everflow RFI, "DCAs" tab), has increased from [redacted] ([redacted] customers) to [redacted] ([redacted] customers) across the same period, indicating that both the volume of debts and also the average value of debts with DCAs has increased.

- The level of external debt recovery costs incurred has increased from [redacted] to [redacted] over the 9-month period to Dec '20, indicating that collecting debt has become much more difficult.
- The value of debts on payment plans has increased from [redacted] to [redacted] – whilst customers are engaging in order to enter a payment plan, this is still a significant increase in exposure given the increased likelihood of insolvencies.

It is also clear that the volume of customers with challenges in meeting their obligations continues to increase through the third lockdown, and that the likelihood is that government restrictions will stay in place for a significant proportion of customers through Q2, particularly the hospitality sector, which has been under pressure for almost a year, and where we continue to see challenges and defaults occurring.

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

We agree with the three guiding principles Ofwat has identified of protecting customers, promoting efficiency and aiming for simple and low-cost intervention(s).

We think there are two further principles that are equally important.

1) Protect and promote competition
In a normally functioning competitive market companies would now be assessing the increased costs incurred from bad debt, and making an assessment of how this impacts on prices being offered to customers. From the UKWRC meeting which we were part of on 15/01/2021, we know that Ofwat, in recognition of this, would like to encourage the market to recover without intervention – as a fully functioning competitive market should. However, the market is not fully functioning as a competitive market. It looks as though Ofwat currently intends to provide a mechanism for recovering bad debt in the more regulated part of the market (where customers are subject to REC price terms), while it does not intend to provide a mechanism for recovering bad debt from customers who are in contract. It is entirely correct to say that a mechanism already exists for increasing contracted prices. However, leaving part of the market to resolve bad debt itself, while intervening where customers are on REC capped prices, will undermine competition. This will be anti-competitive, harming independent retailers and treating customers unfairly:

- REC contracts already include larger margins meaning these contracts already provide more scope for cost recovery. Increasing the REC margin will help those who already ought to be in a better position to help themselves.
- Retailers with a majority of deemed contracts (mostly associated retailers) will be disincentivised from offering any better contracts for the foreseeable future, as by contracting customers they would find it more difficult to pass on the increase in REC prices.
- Associated retailers will have much more certainty of recovering their excess bad debt, because it will happen in a consistent way, in a defined period, across the market. Independent retailers will not be able to give their lenders the same degree of confidence that their bad debt will be recoverable.
- If associated retailers recover their bad debt via deemed contracts over a short period, they will be in a better position than independent retailers when it comes to quoting for

contracts, as independent retailers will for the most part only be able to recover excess bad debt costs through their contracts, or not recover them at all.

- Independent retailers would be likely to suffer reputational damage and lose customers if they put their prices up mid-contract. A key selling point for entering a contract is that the retail price will be fixed for the duration of the contract. The energy market has shown that mid-contract price increases are risky. [redacted]
- If independent retailers are to increase their prices, then there is a significant additional cost of communicating with customers to explain the reasons for the increased price, respond to the inevitable customer queries and complaints surrounding this price increase, and also a higher likelihood that customers will refuse to pay the increased charges by pointing to their contract, resulting in higher recovery costs for retailers. This therefore further increases the disparity in how associated and independent retailers would be treated as a result of this decision.
- Independent retailers could attempt to increase customer prices at contract renewal, but this would take several years [redacted] and given that the default REC price would have returned to pre-Covid levels, an increased price at renewal may not be competitive and there is a risk that customers may not accept a higher price and switch away, thereby stopping the retailer from recovering costs.
- Customers of independent retailers could lose out in various ways – some of the worst ways including their retailer being less able to offer financial support on payment plans, or ultimately their retailer failing.

This principle shapes our response to the following questions, where we outline ways in which competition could be protected and indeed promoted through Ofwat's intervention to enable bad debt recovery.

2) Timing

What is missing is the importance of appropriately timed intervention. Ofwat has been wary of making decisions too early, but retailers – or more particularly their lenders – now need certainty. We suggest that a way of achieving a good balance would be to make some initial decisions which can be revisited at intervals. We would like to stress that the need for certainty is more significant than seeing rapid implementation of the intervention. The timing issue is less about liquidity than lender confidence. If the best solution to excess bad debt (from a competition and customer perspective) will take longer to implement, then provided we gain certainty about its implementation this will be sufficient to give lenders the confidence needed.

If a solution which spreads the recovery of excess bad debt over a longer period of time is not sufficient to provide confidence to lenders to support retailers with any required liquidity, then we would argue that this indicates a deeper issue with the business which would not be solved by recovery of excess bad debt.

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?

This option would more closely reflect a normally functioning market than the alternative included in this CFI of increasing wholesale charges. Depending on how it is done, an amendment to the REC could be our preferred option or our least preferred option.

Short term REC amendment (over one year) - our least preferred option

It appears that Ofwat is looking at a 12-month (or possibly 18-month) amendment to REC price limits. This would reduce the risk of systemic retailer failure, but it would also put independents at a real disadvantage if the amendment was made over this timescale. Associated retailers would have a high degree of certainty that their excess bad debt would be recovered over this timescale, while most independent retailers (those which have grown organically by winning customers) have comparatively few 'deemed customers' would have much less certainty of being able to recover their costs. Although independent retailers like ourselves can increase our prices to recover excess bad debt, this would in practice take several years, as we would want to wait for contract renewals before attempting to do this, for reasons outlined in answer to question 7. In addition, as each contract renewal involves negotiation, there is no guarantee that we would be able to achieve a price increase. With customers who are engaging with the competitive market, there is always a higher risk the customer will switch away – and in this case that the retailer is unable to recover their bad debt costs.

Longer term REC amendment (over three years or longer) - our preferred option
If a REC price increase was implemented over a number of years (three or more) this would be better for the market. This would mean the rate of excess bad debt recovery across contracted and deemed customers would be more aligned. In addition, a smaller price increase spread over several years would be better received by customers, especially as the coming financial year will be tough for all businesses.

Our view is that the REC should be modestly increased over a longer period, by enough to recover an average level of excess bad debt over a period of three or more years. Increasing the REC over a longer period could also stimulate some additional switching by drawing customers' attention to the water market, their bill, and the opportunity they have to find a better deal. We appreciate that the net effect for customers might be that they end up paying less, but this approach would create the right incentives for retailers to think competitively and manage their own recovery. It would also reward better performing retailers – as those with financial resilience, cost-efficient service and effective debt recovery processes will reap the benefits.

Separation of bad debt by contract type
Another potential downside to a REC increase is that customers who have not engaged with the market yet (still including a large proportion of the SME market) are likely to pay more for bad debt recovery than those who have engaged. Consideration should be given when determining the recovery mechanism as to how costs will be recovered across deemed and contracted customers, to ensure that REC customers do not end up subsidising contracted customers.

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

We think the recoupment of bad debt costs through wholesale charges offers a good and fair solution, which we would be supportive of, assuming all bad debt costs (from both deemed and contracted customers) were recovered this way. This would represent a more interventionist approach to recovering excess bad debt, but it would give greater confidence to all retailers and their lenders that they will be able to recover the excess bad debt costs they have accrued on a fair basis. In being fairer to all retailers, whether because of their proportion of contracted customers, or other challenges, this option would arguably be better for customers. It would prevent some (on REC price terms) paying more than others for bad debt recovery, and ensure none are disadvantaged by different treatment of different retailers, and the way that this could stunt competition.

This is not our preferred option, given the potential cost and complexity and that it does not support the promotion of a competitive market as well as our preferred option. However, we would be satisfied if this was the outcome, and we would certainly prefer this option to a short-term price increase.

Our answer to question 11 highlights a ‘hybrid’ option which could address some of the cost and complexity of this solution, while retaining the advantages of fairness and certainty over cost recovery.

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?

The costs and complexity of recovering excess bad debt costs through wholesale charges could be reduced by the hybrid option we set out under question 11. The independent assessment of where charges should be allowed to be recovered would incur some cost, and wholesale companies should have as little administrative involvement with the process as possible. We feel the costs should be shared between all parties (mainly between retailers and non-household customers, but a portion from wholesalers also) – so that it would be in everyone’s interests to keep the costs to a minimum and ensure the process runs smoothly.

We would cite Ofwat’s objectives around promoting efficiency and minimising implementation costs as reasons why we believe that a more smoothed increase to the REC over a longer period would be the best option to resolve the situation as it enables retailers to adjust prices based on how well they have performed relative to each other, is fair and reflects the status of the market as a competitive one, and is also the lowest cost option. However, we would propose a hybrid option (see Q11) as a better option than both recovery through wholesale charges, and also the one year REC increase, given the lower implementation costs.

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.

Our preferred option is outlined in our answer to question 8, through an increase to the REC over a minimum period of three years. We highlight that we would be supportive of recovering excess bad debt through wholesale charges in answer to question 9.

A separate option would be for recovery of charges to take place through the REC, but that those costs were then collected centrally (potentially by MOSL) and shared equitably based on the agreed share of costs incurred by retailers as audited and approved by Ofwat. The benefits of this would be:

- It precludes the requirement for wholesalers to be involved
- It solves the challenges we have raised above around contracted customers
- The costs are likely to be lower than the wholesale charges option

Risks associated with this option are that REC customers end up paying for a higher share of the costs than contracted customers, and that there is a degree of complexity around the mechanism for collecting and then sharing the charges, however we believe these are comparatively simple to the wholesale charges option and would achieve the same result.

This option would be our second preference after a longer-term REC increase, but before wholesale charges and the one year REC increase.

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

As we said in answer to question 7, gaining more certainty on the regulatory interventions that will be made to facilitate the recovery of bad debt is the key 'timing issue'. We are less concerned by the timing of the recovery from a liquidity point of view – although we are concerned that one part of the market could be put at a disadvantage by the timing of a REC adjustment recovery mechanism. It is of course important that bad debt is measured at the right time – and in the right way.

Timing the measurement of bad debt (and defining bad debt)
We do not expect the full extent of bad det to become clear for at least another 12 months. However, we are confident that this will exceed 2% of revenue across the market, and that measures will be needed to begin recovering some of the costs in the short term to avoid retailer failure, as we expect the situation to become even more difficult as government support schemes are unwound. We suggest that an initial assessment of the scale of bad debt is made, and that retailers should be allowed to begin recovering some of the cost of excess bad debt from customers in the financial year 2021/2022.

For example:

- Based on bad debt provisioning, an initial estimate could be that bad debt will crystallise at an average of 3% of revenue, or 2% above a normal year.
- If the 1% excess bad debt was to be shared 3:1 between customers and retailers, retailers could begin recovering costs equal to 0.75% of revenue in 2021/22.
- At March 2022, a clearer picture will have emerged, which for instance may reveal that bad debt stands at 4% or 5% of revenue. A further 0.75% or 1.5% of revenue could then be recovered through charges in 2022/23.
- As Ofwat suggests, we agree that a final true up will be needed at March 2023, to be reflected in prices in 2023/24.

An important added benefit to the above approach is that the costs to customers would be spread over a longer period. If the scale of bad debt should transpire to be closer to 6% or 7% of revenue, it could result in more significant price increases for customers in 2022/23.

Timing the recovery of a portion of excess bad debt

Our view on the timing of the recovery period is that this should not be confined to a short period. Firstly, because if the recovery mechanism is a REC price cap increase, then this would put independent retailers at a disadvantage as retailers with a majority of customers on deemed contracts (mostly associated retailers) will be able to recover the majority of their costs, while retailers with majority contracted customers (independents) will at best be able to recover their costs over three years. Secondly, a longer recovery period would better recognise that the overall level of Covid-19 bad debt will not crystallise for some time, and this would allow for adjustments to be made.

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 a normal commercial market, an increase in bad would impact on prices for the whole market. However, in markets which are comparable to the water market (e.g. energy, insurance) then high-risk businesses would not be able to access such good deals. Despite this, we are not convinced of the ethics of further increasing the disproportionate impact of the pandemic on those sectors most affected, by expecting them to pay for the excess bad debt. Equally, we do not think it would be appropriate to ask those customers who were not impacted as badly to pay a higher share of bad debt recovery charges, while they have been consistently paying their charges and have not caused the increase to bad debt.

As a national retailer, we have provided a detailed analysis of our view of the regional impacts of the pandemic which we hope will be useful as a basis for 'true' comparison – given that differentiating factors between retailers (such as the relative effectiveness of their debt recovery) will obscure regional comparability. We have not found strong evidence of disproportionate regional impacts. Please see our answer to question 2.

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?

If the market was a fully functioning competitive market, the costs of excess bad debt would be split between retailers and customers on the basis of how far retailers were willing to increase their prices in order to remain competitive and what customers are prepared to pay. As retailers and customers negotiated, a split would emerge over time.

We know from working with our debt recovery partners that they receive a success fee when they are able to collect debt on our behalf. Our contract with our main debtor partner stipulates a figure of [redacted] of successful collections. In order to ensure that retailers are incentivised to collect debt rather than allowing it to go bad and then recovering the costs from the wider customer base, we would suggest a split of 3:1 between retailers and customers. This would mean that if retailers are able to recover debts from customers, they will benefit both from a greater share of recovery, and also the immediate cash benefit of collecting as opposed to a longer-term recovery over a period of time.

This also recognises that retailers continue to bear other debt recovery costs as well as 2% of bad debt costs, and therefore this results in an appropriate split for retailers to be able to pass on cost increases, whilst customers do not bear the full impact of the costs of the pandemic.