Introduction

We welcome the opportunity to input into the important topic of customer bad debt costs within the Business Retail Market. We recognise the importance of this subject within the market and whilst this is primarily a Retailer issue we have commented on the requested questions where we felt it appropriate and valuable to do so. We have structured our response to include some general comments and then answers to the specific questions.

General Comments

We are strongly supportive of the well established economic, financial and commercial principal that risks are best allocated to the party most able to manage those risks. This principle is consistent throughout Ofwat's regulatory framework and decisions. In the business retail market cash collection and the risk of customer bad debt, by design, sits entirely in the control of Retailers. Wholesalers have no mechanisms to affect this risk. Accordingly, we believe that any solution should abide by this principle and retain the management of customer bad debt with Retailers. We note that Ofwat support this view that retailers are best placed to manage this risk.

We also recognise the exceptional challenges that the current situation presents and therefore we are fully supportive of appropriate measures that will enable Retailers to better manage the adverse financial impacts on cashflow and costs in this area; but would hope to see a solution that still aligns with the above key principle.

We have provided additional comments and views in the more detailed and specific questions below.

Some of Ofwat's questions refer to the data in respect of customer billing and collection of retailers and we have not responded to these questions. We have commented where we feel it appropriate to do so on the principles and mechanisms proposed

We reaffirm our commitment to work collaboratively with all stakeholders to address the current issues and deliver satisfactory outcomes for all involved; notably the business customers that we serve.

We may not be well placed to comment on the circumstances for self-supply retailers. However, Ofwat's intervention seems to have been motivated by a desire to avoid widespread systematic retailer failure driven by the rapid impact of the pandemic increasing working capital requirements on retailers and bad debts which could have driven defaults. At one level these risks are unlikely to be manifest in the same way on self-supply retailers, who by definition are not collecting revenues from further end customers. On the other hand Ofwat's intervention in this way clearly represents a sub-optimal outcome for a regulator because it will interfere with the processes of rivalry and competition within the market and to some extent could create both winners and losers. There is therefore an argument for common and equal treatment to avoid the risk of real or perceived discrimination.

Additionally, even before the impact of this Covid event, we were aware of widespread concerns over the available margin and the cashflow/working capital requirements associated with the structure and design of the market. Whilst the economic impact of this pandemic event will undoubtedly have further heightened these concerns there is a significant lesson from the experience and there still appears to us to be a structural issue of market design to address. We are concerned that the gross retail margins will be insufficient for some customer groups to participate in the market effectively and, in parallel, retailers operating in such thin margin environments may have very weak levels of financial resilience that require this level of material intervention. Whilst the pandemic is clearly a very abnormal event and we absolutely accept that in a competitive market poor performers are likely to fail, there is a clear trade off here between levels of market entry (and rivalry) on the one hand and the burden imposed on new retailers based on the level of due diligence that Ofwat undertakes before issuing new licences. We consider that Ofwat should revisit its approach to issuing licences to ensure that retailers have sufficient financial resilience to withstand reasonable shocks – this balance is not currently in the right place. Moreover, it should also properly consider the case for further relaxation, and potentially full removal, of REC controls for some, or all of the customer groups.

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

We understand the rationale that this aspect of the NHH Bad Debt issue might be the most material aspect but we also consider that some consideration should be given to evaluating the impact of the cash flow impact (and funding thereof) and also the additional operating costs associated with elevated levels of activity in this area. We believe that these should at least be evaluated in order to support any conclusion on overall costs. Where an impact can clearly be quantified and fully justified it seems fair and reasonable to consider this impact.

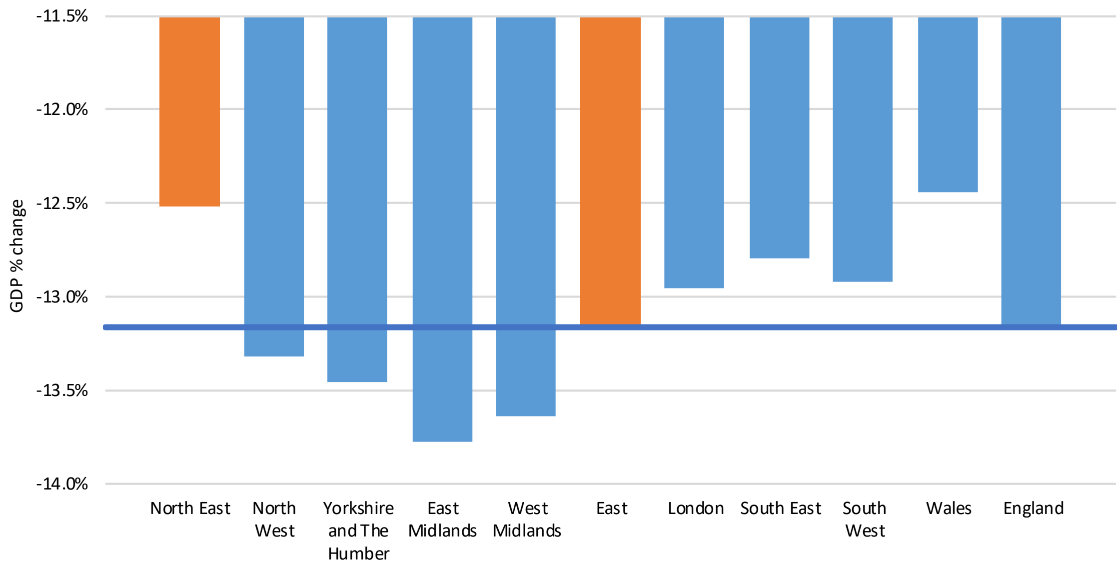
Question 2 - To what extent do you consider that bad debt costs may have differed by geographic region and/or by customer type?

If the market were fully competitive and mature then there should be no need to allow different bad debt costs by region or customer type. If Ofwat was confident that all customer groups could participate fully in the market and switch supplier the full costs of serving each customer group should be reflected in the charges they paid. However, the market still reflects a regional character, driven in large part by the evolution of the legacy charging structures in place and also by Ofwat's default tariff caps, which we are concerned will mean that some customer groups currently cannot reasonably leave their existing suppliers because they will not be attractive to new entrants under the default caps. This means that there will be some geographic differences resulting from the regional diversity of customers as well as the application of regional lockdowns and the tier system in different parts of the country.

Bad debt costs will vary significantly by industry sector or customer type. The differential impact on sectors of the economy and customer types is quite significant with arguably hospitality and leisure being the most impacted. Accordingly, the relative impact of this on different Retailers could vary significantly if a portfolio of customers is significantly weighted in favour of impacted sectors. This difference in customer impact could produce some indirect regional differences.

Across our two operating areas the industrial mix of our customer base has historically included wholesale and retail trade, public services and manufacturing (particularly in the North East). In an early report for Water UK on the impact of Covid 19, PwC provided analysis of the potential Gross Value Added impacts of COVID-19 on different sectors. Applying this analysis and the maximum peak decline impacts from the first lockdown period implies that our regions would not be worse affected than others, but the overall potential reductions in GDP may be significant. This implies that business customers in our regions will face substantial challenges.

Figure 1: Change in GVA at peak decline – based on PwC analysis and weighted using regional population



Source: NWL analysis based on UK Census data of the local industrial mix and PwC, Impact of Coronavirus (Covid-19) on the UK water sector.

We note that Ofwat has also recognised these types of differences exist in the past under its price control assessments. In the domestic retail price control, the cost assessment models adopted by Ofwat at PR19 use various cost drivers including the proportion of households with default (an Equifax variable) as well as deprivation and bill size to account for regional differences. Furthermore, at PR14 Ofwat allowed adjustments to the retail cost allowances for some companies where they argued that a simple cost to serve approach did not account for factors such as bill size and deprivation.

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

We would be comfortable with either of the described options and endorse the objectives that the approach needs to be consistent and verifiable. For simplicity we would support the “statutory accounts basis” particularly as these are independently audited. Retailers that over-estimate and subsequently over-price the recovery of bad debt costs will naturally be less competitive within the open market. So this is a natural commercial counter-balance to over provision coupled with the assurance provided by independent professional auditing of the numbers. The extent to which customer switching is constrained by existing contractual terms would need to be understood but potentially a mechanism could be included within the REC that allowed any customers experiencing price increases above a prescribed level would automatically be given an option to change supplier or renegotiate terms for a defined period.

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)?

If recovery is to be managed entirely by amendments to the REC then for simplicity we see this as the most effective mechanism. It is important that compliance with the relevant accounting standards is verified by specific and detail third party compliance statements.

The only point of difference would be the need to report separately on bad debt costs associated specifically with Covid-19. Some guidance on how these costs are separated from non-covid related bad debt costs will potentially be required. However, as this mechanism is only seeking to allow the recovery of bad debt costs above the base historical level on a Retailer specific basis then for simplicity we would consider it reasonable, and simple, to assume that elevated debt levels for all post March 2020 invoices should be considered attributable to Covid-19.

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 consider that having a more prescriptive and separate basis for the reporting of bad debt costs will increase complexity and cost without necessarily producing more robust results. Existing accounting standards and practices should be adequate to ensure equity of comparison and approach. Retailers will be better placed to answer this question.

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?

Overall we currently envisage that the impacts of the Covid -19 event will be felt/observed commencing from March 2020 and will run through into the 2021/22 financial year and in all probability potentially even the following financial year. We recognise though that the position continues to evolve and a degree of flexibility in approach should be included but not at the cost of providing regulatory certainty to customers and market participants.

(a) Our view is that the analysis of bad debts costs should assess the historic pre-march 2020 position, but utilise an average (perhaps 3 year average) historic position as significant year to year differences can arise, and continue to monitor the position until the end of the 2021/22 financial year. We would envisage a time-line that would see a final truing up period in the financial year 2023/24.
(b) As stated above we would envisage a 2 year period commencing march 2020 over which bad debt costs are reported and monitored for Covid-19 purposes followed by a final truing up year in 2023/24.

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.

As a wholesaler we are unable to provide an evidenced view on this question in relation to Non-Household bad debt. Intuitively the economic impact of Covid-19 through already observed business failures and future business failures will increase the scale of bad debt costs, particularly where the Government support packages around furlough and other measures are removed but we would envisage Retailers being able to provide a more meaningful, and evidenced, assessment of this point.

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 are supportive of the 3 objectives stated but would recommend the extension of the customer protection principle to not only include the risk of systemic Retailer failure but also the risk of any other consequence that could materially adversely impact the provision of water and wastewater services.

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?

We strongly believe that recovery of any increase in bad debt costs is accommodated solely via adjustments to the REC. This approach is the only one that maintains the principle of the risk being allocated to the party best able to control and manage that risk and that are currently funded to do so.

In our view Option (1) amending the REC as described within the paper is workable and could perhaps form the basis of an acceptable approach; but Retailers would be better placed to comment on this aspect.

An option that could merit consideration would be a much broader relaxation of the REC to allow normal commercial rules to apply as the ability to switch supplier is a construct of the market. This could be as far reaching as the full removal of the default tariffs across all customer types and utilising a simpler discrimination requirement "Retailers must ensure the default tariffs are reasonable and non-discriminatory" as the primary protection. We believe that this would increase rivalry in the market for the benefit of customers. Alternatively, as proposed within the report a simple increase in allowable margin up to an increased value would be allowed across Customer Types 1 & 2. These approaches afford the simplest and most efficient approach.

This approach would primarily use the commercial nature of the market and a customers right to switch as the primary protection for a customer but with an upper cap on the margin retained for customer types 1 & 2.

Given the current differential in switching rates and awareness amongst the smaller size customer type this would perhaps favour the controlled elevation in REC margin as a first step.

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 are not supportive of this approach which would be flawed in theory, create poor incentives, add significant complexity, be challenging to implement in practise and further exacerbate the inconsistency of Ofwat's approach to addressing the impacts of the pandemic on the sector.

1. It breaks the principle of risks being allocated to the party most able to control the risk. It is therefore inconsistent with other decisions Ofwat has taken elsewhere which support this principle.
2. Moreover, where costs are transferred to wholesalers there is no incentive for Retailers to manage these costs efficiently or effectively. The retrospective nature of utilising such an approach further compounds this position and creates a risk of moral hazard.
3. It adds further complexity and regulatory intervention into what is fundamentally striving to be a deregulated competitive market. This introduces the risk of unintended consequences.
4. It is difficult to see how this change would be implemented, re-openers for the existing wholesale price controls must be based on clear materiality assessments[1] and it is not clear to us that these materiality assessments would be met. These materiality thresholds exist precisely to avoid wholesale charges being changed as a result of unforeseen events that drive more minor impacts and cost pressures. These impacts are clearly not material for wholesalers on their own and if

[1] See for example: https://www.ofwat.gov.uk/regulated-companies/price-review/interim-determinations/

Ofwat considers that the impacts are material for retailers, they should adjust the retailer default caps directly.

5. It would create a clear inconsistency in the policy approach to assessing and managing the impacts of the pandemic on different parties. Whilst Ofwat has made significant interventions to support retailers in the non-household market in relation to the impacts of the pandemic on cashflows and bad debt it has to date given no clear signals at all about any support for wholesalers. This is already surprising and inconsistent given the scale of the impacts identified from the Frontier Economics work undertaken for Ofwat and Water UK[2]. Moreover, we note that wholesalers have already accepted negative impacts to their own cashflows driven by the previous interventions and Northumbrian Water has not sought to use any of the Government furlough or other support schemes.

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?

As stated in our response to Question 9 we are opposed to this approach and have reservations about the additional costs and complexity that such an approach introduces into the market. It is not possible to fully quantify the scale of these costs until a greater understanding of the final detail of the approach is available; but both of the mechanisms proposed have significant practical problems within the current market settlement and invoicing arrangements. Accordingly, a high degree of additional cost would be envisaged in the implementation and operation of such an approach.

We note the proposed "straw man" and have concerns over the practical administration of this on a Retailer by Retailer basis. The potential VAT implications of the approach would also need to be fully understood.

There is no evidence provided, or available that suggests that the scale of the issue merits this level of intervention and consequently the additional costs and risks to distortion of the market that this approach represents.

[2] See: https://www.ofwat.gov.uk/wp-content/uploads/2020/12/Economic-impacts-of-COVID-19-on-the-water-sector-Dec-2020.pdf

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.

No, we are strong supporters of the need to amend the REC and see no other approach as more favourable or better suited to meeting the requirements of addressing this potential for elevated bad debt costs resulting from Covid-19.

The retail component of the business retail market as currently structured needs to be sufficiently resilient, for efficient trading parties, to a range of adverse economic impacts on a cyclical basis without the need for significant regulatory intervention. The only practical way we see to achieve this is through adjustments and alterations to the REC.

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

The overall time line being considered is reasonable and appropriate and aligns with our current expectation in respect of the resolution to the current Covid-19 event. The one area of concern or comment that we would make is the length of time it will take for Retailers to be able to recover the additional costs. Recovery in effect wouldn't take place until the financial year 2022/23 and we think that this time line might place too high a burden on Retail cash flows. In the context of this pandemic event we consider that some form of interim measure would be appropriate as soon as possible, and certainly for the financial year 2021/22. A trueing up mechanism has been proposed as being a key component of any solution and therefore any immediate temporary measures could simply form part of this mechanism. The benefits of interim action would be a longer period over which the customer funding element of the additional bad debt costs is recovered. This provides customers with potentially a smoother recovery profile. Additionally, more immediate action would mitigate funding requirements for Retailers in the current challenging economic environment.

In practical terms we envisage that it might now be too late to incorporate a REC change for 2021/22 but the potential option for a mid-year REC adjustment could be considered.

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

We consider this to be an extremely challenging area to address without introducing a risk of unintended consequences in one form or another; be that price distortion, cross-subsidy or some form of unintentional bias. The detailed reporting and analysis required to enable a good degree of accuracy in this area would be onerous and very difficult to accurately assign. Recovery via the REC already does to some extent "pool" recovery and affords a degree of protection across the existing customer banding. Therefore, we do not see that any additional pooling approach utilising customer groups or geographic regions affords any significant benefits in the recovery of excess bad debt costs.

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

We believe that the balance of cost sharing proposed to date up to the 2% of turnover level is reasonable and appropriate. The proposed approach in respect of excess costs above this 2% level is understood but lacks certainty. However, given the uncertainty over the scale of the issue and the potential for significant variances between retail organisations a degree of flexibility around the approach will inevitably be required. The option for a graduated scale would seem to suggest a reasonable balance between certainty and scale; whilst still maintaining an incentive to effectively manage these costs.

One other option would be to allow the competitive nature of the market and a customer's right to switch act as the main incentive to manage these costs effectively. In essence this would see customers funding up to 100% of the excess costs should a retailer seek to pass on the full cost to their customers. It is then a customer's ability to switch that would act as both the protection for a customer and the incentive for a retailer to keep these costs as low as possible or even to not to fully pass on the costs to the customer. This approach utilises a natural competitive pricing approach to manage these costs.

Northumbrian Water Limited

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