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

Severn Trent response

We welcome the opportunity to provide our views on the response to the exceptional bad debt costs that retailers may incur as a result of the Covid-19 pandemic.

Like other wholesalers, Severn Trent has played its part in supporting retailers through the challenges presented by the first national lockdown. We are pleased to see that the situation is returning to normal and that retailers are now generally able to secure their own sources of credit. We understand that the early part of 2020 was a very unexpected situation, where exited wholesalers were expected to provide to support to retailers; going forward we think that the solution should be applied within retail charges. In our view the blurring of responsibilities is not desirable and should be avoided where possible, so we favour a recovery mechanism that is applied through the REC.

Although many of the questions in the CFI are retailer issues in which a wholesaler has no direct interest, we believe that it is important for any solution to be applied at a national level – as Ofwat has previously suggested – and to apply a level playing field between retailers. Given that retailers are not regulated to the same extent as appointed companies, there will be a great deal of variation in the way that they provide for bad debt and we would not want to see customers in our region pick up excessive costs as a result.

If you would like to discuss this response further, please do not hesitate to contact me or a member of my team.

Kind regards

Shane Anderson

Director of Strategy and Regulation

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Response to individual questions

As noted in our overview, we do not have a direct interest in the way in which the excess bad debt should be measured (Q1 to Q7), but we have provided some brief answers from a wholesale perspective.

Q1 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 agree.

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

Bad debt will vary by region and customer type, but we do not think that these factors need to be considered within the recovery mechanism. It should simply aim to treat retailers evenly rather than attempting to model what the level of debt in an area ought to be.

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

The approach should be based on rules that can be applied consistently, because retailer approaches could be extremely varied. Given that some retailers will be very new companies, it will not be possible to judge the appropriateness of their accounting policies based on historical data. The amount claimed should be audited and that if debt that has been written off is subsequently collected, there should be a mechanism to ensure that this is returned.

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.

As noted above we think it is likely to be fairer if Ofwat laid out a set of prescriptive rules because retailer accounting policies may be very varied.

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?

Given that many businesses have been provided with a range of support measures to help them through the pandemic, it will take time for the effects to crystalise. Businesses are likely to fail once the economy re-opens and the support is withdrawn. We think this might justify assessing the excess impact over a longer period.

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.

We are not in a position to comment on the likely scale of non-household bad debt.

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 that these are sensible objectives which are in line with Ofwat's duties.

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?

As we set out in our overview, we think it is important that excess bad debt should be recovered through retail charges. The support which wholesalers (particularly existed wholesalers) provided during the early part of 2020 represented a blurring of responsibilities which is not desirable.

We recognise that there could be difficulties in applying a solution through the REC, because the retail component represents a contestable margin. Current retailers who have incurred the excess bad debt could claim this through their charges, only to be under-cut by new entrants who are not burdened by these costs. However, we would suggest that this could be addressed through additional rules, for example requiring licensees to recover this cost as we set out below.

In response to Ofwat's April 2020 consultation, we suggested that a potential solution could be for Ofwat or MOSL to charge a fee to all non-household retailers over a number of years – this would be part of the gross margin that they could charge on to their customer base. This would be a national solution, which could be applied to non-households across the country quite easily; it could even be apportioned between retailers in the same way that MOSL's existing charges are allocated. The amounts due to each retailer would then be rebated to the company that had incurred the excess debt.

While new retailers might replace the existing ones, they would still incur this fee and Ofwat or MOSL would still be able to return these rebates to the retailers that had made the claim. Recovering the excess debt in this way could have cashflow advantages since they would not have the working capital implications arising from an addition to the wholesale charge. The fee rebate would also represent a guaranteed revenue stream that retailers could potentially use to secure finance in the short term.

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 do not support the use of the wholesale charges to recover bad debt costs. In principle, this represents a blurring of responsibilities, but there are practical considerations besides this. We describe these in response to Q10.

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?

If wholesale revenue controls were amended to allow for the recovery of retail debt, this would not necessarily be paid by non-households. There are different charges for residential customers, but no separation within the form of control. To avoid an impact on households, there are two approaches that Ofwat might take:

- It could introduce a charging rule to state that market-related costs should not be borne by households (which would codify existing DEFRA guidance). However, it would be difficult to prove that this had been applied without mandating a specific charge to non-households which covered these costs.
- It could separate the wholesale controls between households and non-households. This would be excessive for the scale of the issue and would be another magnification of complexity; it would double the wholesale controls from four to eight. This would also exacerbate bill volatility for wholesale customers because variations in non-household revenue would then fall on business customers alone.

If a national solution is to be applied – in line with Ofwat's early thinking - then the wholesale route would also increase the complexity of the redistribution. Wholesalers in one area would need to remit charges to a central body, or to retailers in other regions with whom they may have no relationship.

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 approach would be an amendment to MOSL or Ofwat fees that are recovered from retailers, as described in our response to Q8. Alternatively, this levy could be redistributed by a third party. The additional fees could be recovered through retail charges and returned to the retailers that had claimed for excess bad debt costs.

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 set out in Q8, the levy or fee rebate could provide a guaranteed revenue stream for retailers. This might enable them to finance the costs that they have incurred and spread the impact to customers over a period that does not cause adverse effects when they are trying to recover from the effects of the pandemic.

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 strongly support a national solution, as suggested in Ofwat's April consultation.

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 retailers have borne the first 2% of bad debt costs in their entirety, it would seem reasonable for the excess above this level to be spread across the non-household customer base.