Regulation
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Dear Shaun,

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

Thames Water welcomes the opportunity to respond to this consultation. From the outset of the pandemic, we have been mindful of the potential harmful impact on Retailers and the non-household market. We want to work with market participants to find the most effective solution possible to mitigate the impact of customer bad debt.

There are two separate issues identified in this paper. Firstly, there is the calculation of the financial impact of the virus. This includes how to calculate "historical", "elevated" and "excess levels" of bad debt. Information for this is held by the Retailer and not the Wholesaler. We do not wish to influence the process that may or may not favour an individual Retailer in the market. We have therefore not commented on that part of the call for inputs. The second issue is in the design of the payment mechanism itself. In contrast to the first, we are able to comment on this from a Wholesaler perspective. Our response will therefore focus on these questions in responding to this Call for Inputs.

From the perspective of payment administration (and not calculation), we favour a design that minimises the efficient cost of its operation to benefit all interested parties. Amending the Retail Exit Code (REC) (option 1) to facilitate payments between Retailers seems to us the most effective way to achieve this objective because:

- There will be a single transparent national implementation cost.
- Suitable regulatory oversight is already built into the process of changing the REC to protect the interests of *all* classes of customers and Retailers.
- The time taken to develop the scheme would probably be the fastest of the options presented in the Call for Inputs.
- The REC is a good mechanism to administer the payments given its position in the market.

We do not favour option 2, "Recovery from business customers via wholesale charges" for the following reasons:

- There would be extensive duplication of both effort and cost between Wholesalers producing similar payment systems that may have to be coordinated. This is likely to be higher than the cost of a single centrally administered payment mechanism. The solution is simply added to an existing code for what is after all, a national and not a regional issue. This would add complexity for Retailers needing to deal with multiple Wholesaler systems rather than the available standardised option.
- This option is likely to be slowest at paying out when quick resolution is desirable for a Retailer, especially if there is a potential liquidity problem in the market.
- The payment mechanism could potentially disrupt the Wholesaler's carefully balanced cash flow allowed under the Price Review and we note a licence change may be necessary to implement the option, again slowing its implementation.
- Payment processing is likely to be less transparent and inflexible when compared to the REC option.

You invited alternative solutions in question eleven. We support REC models to deliver the payment solution. Our desk research has shown that key to the payment design is to understand the likely number of payments and their amount. This suggests using a MOSL change proposal to design a process to provide a fully commercially designed solution.

Attached to this letter is an Annex where we provide our detailed comments on each of the questions, where it is appropriate for us to comment, raised in the discussion paper.

Yours sincerely,

[redacted]

Peter Trafford
Head of Regulatory & Market Economics

Annex

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?

For the reasons set out in the cover letter we do not provide any comments on this question.

Q2: To what extent do you consider that bad debt costs may have differed by geographic region and/or by customer type?

For the reasons set out in the cover letter we do not provide any comments on this question.

Q3: What is your view on the best approach to measure bad debt costs arising, in ways that are objective, consistent and verifiable?

For the reasons set out in the cover letter we do not provide any comments on this question.

Q4: 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?

This is an issue for Retailers to decide. We note that timings associated for the provision for bad debt may well be anchored to the terms and conditions of the contract to supply and the Retailer's accounting policies. This should readily define the period.

Q5: 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.

For the reasons set out in the cover letter we do not provide any comments on this question.

Q6: 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 support Ofwat's objectives as stated on page 20. However, we consider they could be developed further:

- Rather than using the words "promote efficiency" in objective two, we would suggest that using Ofwat's own words, "preventing distortions to competition" better reflects the surrounding text in point two on page 20. This is consistent with our view of using market and commercial mechanisms, where possible, to solve industry wide problems.
- It is our preference for the regulator to use the term minimising "transaction costs" rather than "implementation" in objective three as this we believe has a more precise economic meaning[1] in this formulation and identifies many of the underlying issues that will arise in developing this scheme.

[1] See for example, Williamson in Schmalensee and Willing in the reference work *Handbook of Industrial Organisation* (1989)

In one respect the objectives are incomplete. Wholesalers have legitimate interest in this process but there is no mention of them in the objectives. This is acceptable so long as they do not have to administer the scheme. We note that in other network utilities (gas and electricity) where there are specific payment roles, they also have revenue protections given their pivotal role in the functioning of their sectors[2].

Q7 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 support the use of amending the REC to recover excess bad debt costs for the following reasons:

- The REC is effective at pooling resources to facilitate payment between Retailers and therefore lower transaction costs through membership. This is the key efficiency argument for its existence, so we do not see a reason not to extend this existing characteristic.
- Costs are more transparent and controllable using industry processes rather than the alternative of having the scheme administered by the Wholesalers.
- Regulatory oversight for this process is comprehensive through the review of change proposals against their primary duties.

Q8 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 favour this option and consider that there are some important disadvantages to this approach:

- It is highly likely to increase transaction costs of administration for all parties:
    - Systems and process: all Wholesalers will be undertaking some form of process change including ongoing assurance work and may even need to amend or even create new systems depending on the precise details of the option chosen.
    - Duplication and usage: Wholesalers will set up payment systems that may or may not be fully utilised depending on the impact of Covid-19. This contrasts with the REC which is a centralised national system.
    - The development of the process will not be as transparent for Retailers when compared with using the REC.
    - Retailers are likely to incur additional costs from interfacing with multiple Wholesaler systems instead of one standardised approach.
- The process will potentially increase price volatility in wholesale charges for Retailers as further adjustments will need to be made to facilitate revenue transfer during the year. This could impact on the type of contract and risk that Retailers can offer in a fixed price contract.
- Payments are likely to be slower than a REC modification for Retailers. This could lead to a lag in payments potentially creating shortfalls in liquidity for those vulnerable Retailers affected by Covid 19.

[2] For example, in connections "Power to Recover Expenses" Section 19 Electricity Act 1989 as amended

- It may be a complex task to set up the required regulatory framework such as Licence change, new charging rules, reconciliation, and reporting schedules.

Q9 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?

It is difficult to estimate the costs as the options presented are not yet developed enough to give a precise estimate, so we have set out some initial comments and views. However, we are able to identify the issues we may have using the framework outlined in the consultation (Table 1).

Table 1 Dimensions of change for Wholesalers

Stage in the process defined by Ofwat	Comments and views
1. Estimate the aggregate level of outturn excess bad debt costs that Retailers are allowed to pass through to end customers, after applying sharing factors.	Information about outturn excess bad debt will be difficult to estimate and creates a regulatory risk for us if we were allocated this task (the text does not indicate who). It is the Retailer who will know the payment schedule and the *prospect* of being paid (as per their accounting policy). Whoever calculates this may have no ability to differentiate between historical, elevated and 'excess' levels of bad debt costs without substantial auditing oversight. They will have no idea of the scope and nature of debt without a Retailer reporting not just the outstanding amount, but they would also want market intelligence about the prospects of future payments to inform them of aggregate levels of debt.
2. Calculate an average excess bad debt cost per customer, based on the number of customers a Retailer has at the end of the relevant period.	This will require changes to process or even systems to add functionality. If this is going to be a national average, then Wholesalers would have to cooperate with each other. The average is not always representative for any one Retailer. Any outliers that may be in a Retailer's portfolio could be significant, especially for smaller Retailers
3. Uplift wholesale charges to all Retailers by the average calculated under step 2.	This is a change in tariff that will go into our charging cycle. This is likely to be slow moving. At present tariffs are only updated annually. If there are any further regulatory changes, for example licence change, then this can delay the process further.
4. Disburse amounts due to each Retailer through one of two methods: a. Via a central fund. Wholesalers would invoice Retailers for the wholesale charge which would include the uplift applied to recover (the portion of) excess bad debt costs. Wholesalers would pay the portion of the wholesale charges that relates to the uplift into a central fund. The administrator of the central fund would disburse monies to Retailers in respect of the bad debt costs to be recouped. (Note the identity of the administrator is yet to be determined).	This involves developing a new type of invoice not seen before therefore scope for process or even system changes and associated assurance processes will be required. The central fund would not be administered by us so we would be under instruction from a third party ("the central fund administrator"). New and novel security frameworks will also need to be developed.

Stage in the process defined by Ofwat	Comments and views
b. Via a rebate to Wholesaler charges collected from Retailers. Wholesalers would invoice Retailers for the wholesale charge including the uplift applied to recover (the portion of) excess bad debt costs. Instead of paying into a central fund, monies owed to Retailers in relation to excess bad debt costs would be netted off future wholesale charges to provide a rebate to Retailers. Again, this would be on the basis of the pass through each Retailer is warranted to collect.	As with a, this involves developing a new type of invoice not seen before and therefore significant system changes and associated assurance processes. This could alter our predicted cash flow as we will (a) not have an idea of the scale of the payments and (b) what we will netting off future charges

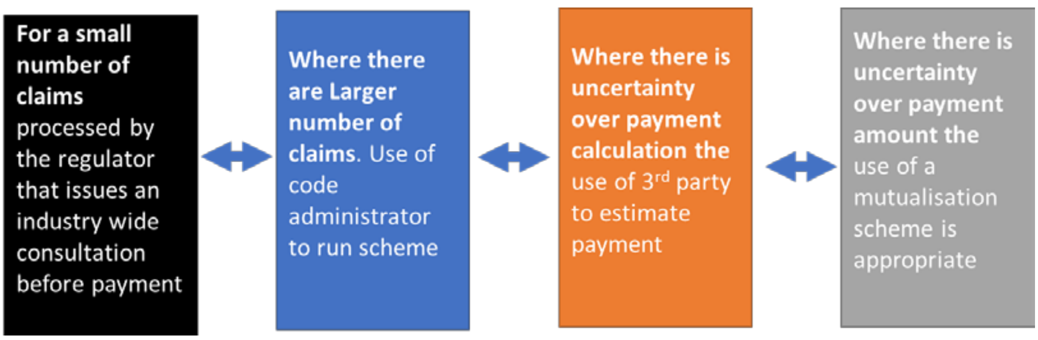
Q10 Aside from amending the REC or recovery through the wholesale charges, do you have any views on whether other mechanisms or approaches to amending regulatory protections may be appropriate? If yes please describe your preferred approach and your view of why it may be warranted.

Our position is that it could be possible to build a composite model using design features of other inter retail payment mechanisms or adopt a suitable model in its entirety. This would have to be fully supported by Retailers.

We have undertaken some desk research of inter supplier payment arrangements between gas and electricity suppliers. Our findings are as follows:

- The significance of the *number* and *value* of the claims and transfer is linked to payment transfer design.
- In each case customer supply point and volume are used in the sharing calculation and not the region.
- Most of these options use like for like supply points as the means by which costs are allocated.
- In cases where there are small numbers of claims a centrally processed system administered by the regulator works well precisely because it is only used infrequently and incurs negligible ongoing costs. In cases where there are more claims the use of a code administrator is preferable as it provides the right balance of regulatory scrutiny with signatories to the code an input into the process. If there is an uncertainty over payment calculation a third party is used to guarantee neutrality and accuracy. If there is uncertainty over the payment amount, then a mutualisation scheme is appropriate (I.e., share costs over the market). Figure 1 summarises the findings.

Figure 1 Lessons from payment arrangements between Retailers



Finally, as business retail is a competitive market, we strongly prefer a commercially driven solution between Retailers to determine their choice of regulatory design where possible for example adapting the MOSL. Collectively Retailers are incentivised to identify a solution that works for the following reasons:

- Retailers own contracts that will have late payment terms in them by which they are in the best position to understand their individual portfolio risks.
- They are also the best placed to understand the costs associated with bad debt both as a collective and individually.
- Retailers will also be the first to experience the actual impact on the water sector of the virus as it develops.
- They can work within the neutral framework of industry governance with the oversight of the regulator.

Q11 What is your view of the appropriate timing for the measurement and recovery of (a portion of) any excess bad debt costs?

For the reasons set out in the cover letter we do not provide any comments on this question.

Q12 Do you agree that it makes sense to 'pool' recovery of (some portion of) excess bad debt costs across customer groups and/or regions?

For the reasons set out in the cover letter we do not provide any comments on this question.

Q13 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 are hopeful retailers acting responsibly can identify customers who can pay but might need their credit extended and can demonstrate appropriate measures are in place in first the instance. If levels of debt are extraordinary a new mechanism may be required.