

This response relates to the November 2020 consultation “Call for inputs: Covid-19 and the business retail market – customer bad debt costs”.

We welcome the opportunity to provide our views to this call for inputs relating to customer bad debt costs in the business retail market. Whilst many of the questions are focussed on retailer activity and experience, and therefore not relevant for United Utilities as a wholesaler, we have responded to the questions where we consider that we are well placed to provide some insight.

When considering the two proposed approaches to recouping excess bad debt we see substantial issues with both, but do have a view of an approach sitting somewhere in between the two that would provide a better outcome.

Utilising the REC to recover funds by increasing the cap on charging for customers on deemed contracts distorts the level playing field and focusses recovery solely on those customers who have yet to switch, or agree a contract. Where one retailer tries to recover monies by utilising an increase to the REC cap this creates additional margin which would create an incentive on customers to avoid this recovery by switching to another retailer to avoid this additional charge. The remaining excess bad debt would then have to be recovered on those customers yet to engage in the market, primarily smaller customers, who are still on a deemed contract. It would seem extremely unfair and disproportionate to focus the recovery of this excess bad debt on this customer group.

Alternatively, recovery of excess bad debt through an additional debt recovery charge being added to wholesale charges would likely require a variation to price controls, which would either delay payments being made to retailers, or delay the recovery of payments by wholesalers. There is currently no regulatory mechanism (outside of the price control) that in our view that could be legitimately used to justify an additional bad debt recovery charge being added to the wholesale charge. It may be possible to use the PR24 process, but this would mean a substantial delay to recovery.

We propose an alternative solution utilising the Revenue Forecasting Incentive (RFI). This avoids creating an un-level playing field and focusing recovery on particular customer groups, whilst also avoiding the creation of new regulatory mechanisms. The RFI enables under recovery of wholesale revenues in the NHH market to be recovered in future years. If the excess bad customer debt were treated as a sum that could be offset against wholesale charges, and wholesalers could then account for that as unrecovered wholesale revenue the issues detailed above could be avoided. This would require:

- changes to the market codes, to enable retailers to offset the excess bad debt against wholesale revenues (for example as a credit note), but in a way that enabled that value to be excluded from the retailer’s recovered margin.
- A minor amendment to the RAGs to enable that credit note to be included (as an offset) to reported wholesale revenues (as this would then enable subsequent recovery naturally through the RFI mechanism).

These changes seem to us to be relatively minor, and preferable to all the potential alternative approaches. This approach would still require audit of the bad debt calculations, but would avoid other steps that could extend the timeframe for recovery.

Wholesalers would need to be assured that they would not be penalised if the application of this led to an overall revenue variance of over 2%, and also that recovery of the credit note value would be at 100% (which should be the case if processed through the RFI), as these are circumstances outside of their control.

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It should be noted that this approach would involve wholesalers again providing some support to the market, however if this approach helps secure the retail market, then the cost is not too great. This approach would also enable the rapid realisation of this excess bad debt meaning that retailers would receive funds quickly and that wholesalers would have surety of recovering their required revenues.

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 are not responding to this question.

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

We are not responding to this question.

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 are not responding to this question.

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 are not responding to this question.

Question 5 – (a) What is your view on the period over which we should be measuring bad debt costs arising,

We are not responding to this question.

(b) What in your view is the appropriate time interval following this for the measurement of bad debt costs?

We are not responding to this question.

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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 responding to this question.

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?

In broad terms the objectives set out within the consultation appear to align with Ofwat's duties and the interests of all stakeholders. For any option that requires recovery through wholesale charges, it should also not conflict with the requirement of companies to comply with Ofwat's charges scheme rules, and should also not conflict with condition E. In respect of condition E, if subsequent recovery is to be focused on any particular charging group, then it would need to be clear that Ofwat would consider such discriminatory allocation not to be undue.

It is also worth considering that any recovery mechanism must, in our view, be clear and straightforward to implement for all stakeholders including wholesalers. It is also clear that it is in the interests of all stakeholders, including wholesalers, to work to ensure there is no systematic retailer failure, therefore we expect that the support and engagement that has been provided by all stakeholders to date will continue. To support retailers it seems clear that minimising the time any process takes for retailers to be recompensed should be an aim of this process.

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?

There is a substantial fault with the proposed process utilising the REC to recover excess bad debt. If a retailer tries to recover monies through an increase to the REC this creates an un-level playing field in the market. To avoid the recovery of this debt owed to retailers it would be common sense for the customer to switch to another retailer to avoid this additional charge. This consequences means that that retailers would have a choice of not recovering this money owed, or losing customers. In addition, the recovery of these bad debts solely through the REC would focus the recovery on a group of customers who have as yet not chosen to switch provider, or sign up to a new contract. It would seem extremely unfair and disproportionate on those customers, which include a larger proportion of smaller customers.

Therefore we believe that any recovery mechanism should **not** assume recovery through adjustment (increase) to the permitted margin allowed by retailers. This is consistent with our proposal that is set out in the introduction to this response, i.e. that:

- Market Codes to be amended to allow retailers be permitted to provide a credit note for excess bad debt to offset its payments to wholesalers, and for this value to be excluded from the retailers permitted margin;
- RAGs to be adjusted to allow that credit note to be included (as an offset) within reported wholesaler revenues; and
- The resulting under-recovery of wholesaler revenues to be (naturally) recovered by wholesalers through the RFI mechanism.

These changes seem to us to be relatively minor, and preferable to all the potential alternative approaches. This approach would still require audit of the bad debt calculations, but would avoid other steps that could extend the timeframe for recovery.

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It should be noted that this approach would involve wholesalers again providing some support to the market, however if this approach helps secure the retail market, then the cost is not too great. This approach would also enable the rapid realisation of this excess bad debt meaning that retailers would receive funds quickly and that wholesalers would have surety of recovering their required revenues.

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

It is unclear how this recovery would be undertaken, on its own, given that companies operate under total revenue controls. The proposed recovery of additional retailer costs from the wholesale charge does not align in our view with the normal process (as set out in condition B) for establishing the revenue permitted to be recovered from customer charges (i.e. in accordance with the preceding price control).

Furthermore, any option that requires recovery through wholesale charges would also need to not conflict with the requirement of companies to comply with Ofwat's charges scheme rules, and should also not conflict with condition E. In respect of condition E, if subsequent recovery is to be focused on any particular charging group, then it would need to be clear that Ofwat would consider such discriminatory allocation not to be undue.

We believe that there is currently no appropriate mechanism which would enable recoupment of retailer bad debt costs through additional wholesale charges within the current AMP.

A more straightforward approach would be to recover excess bad debt through the price review process at PR24 (inclusive of the cost of financing that cost until 2025). This way the normal processes to consider costs and identify recovery would be available, however this would mean that recovery of excess bad debt would only be possible from AMP8.

If the excess bad debt were to be recovered through the wholesale charge in the way envisaged in the CFI, this recovery would need to be factored into the charges setting process which adds time with charges for FY22 already determined. Potentially new systems and processes may be required also extending the timeframe. It is unclear if this lengthy a process would be acceptable or appropriate for retailers at this time.

Therefore we believe that any recovery mechanism should not assume recovery through solely wholesale charges in a way that requires amendments to price controls. This is consistent with our proposal that is set out in the introduction to this response, i.e. that:

- Market Codes to be amended to allow retailers be permitted to provide a credit note for excess bad debt to offset its payments to wholesalers, and for this value to be excluded from the retailers permitted margin;
- RAGs to be adjusted to allow that credit note to be included (as an offset) within reported wholesaler revenues; and
- The resulting under-recovery of wholesaler revenues to be (naturally) recovered by wholesalers through the RFI mechanism.

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It should be noted that this approach would involve wholesalers again providing some support to the market, however if this approach helps secure the retail market, then the cost is not too great. This approach would also enable the rapid realisation of this excess bad debt meaning that retailers would receive funds quickly and that wholesalers would have surety of recovering their required revenues.

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?

We are not responding to this question.

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.

We are not responding to this question.

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

We are not responding to this question.

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?

Customer groups

It would be possible to link the level of bad debt to customer group either utilising the data held in CMOS, or through retailers individual systems, however there are factors both practical and ethical that would need to be considered first. The practicalities also depend on whether such targeting of recovery is performed through wholesale charges, or through retail charges. We respond here from the viewpoint of this being performed through wholesale charges.

The practicalities of attributing excess bad debt to specific customer groups would require the attribution of bad debt against specific sites where a customer undertakes a role that encompasses various activity. For example a brewery with a numbers of pubs, manufacturing base and distribution centre all of which may sit in different categories of levels of bad debt. Therefore, for an accurate distribution of bad debt amongst customer groups there would need to be a substantial exercise undertaken to identify the activity

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undertaken by all supply points and level of associated bad debt. The alternative would be to use a less accurate approach that could utilise data currently held within CMOS. This could lead to customer complaints adding to the workload. The time, effort and expense spent to undertake this exercise, if it is to be accurate, would not seem insubstantial. We have previously undertaken such an activity (when identifying schools in the UU area of appointment) and we can attest to the complexities of accurately identifying a seemingly straightforward customer group. Issues also arise from customers at the boundary of being included/excluded from such adjustments, leading to grievances and feelings of unfairness. We would anticipate the exercise required to identify the relative bad debt costs for different customer groups could be extremely complex and risky.

A factor that is both practical and ethical that should be carefully considered is the impact on the individual group of customers. Targeting the recovery at the group with highest levels of bad debt is likely to be targeting the group of business customers most affected by Covid-19 and the mitigation associated. Therefore it is likely that this group may well be in the position least able to cover those extra costs. It is not clear what legitimacy we would have as a wholesaler to target recovery from customers. Therefore, if excess bad debt costs were to be recovered from specific customer groups we would need assurance from Ofwat that such a discriminatory allocation was legitimate.

Although some customer groups may have generated more bad debt, it is not clear that they are viewed by society as culpable, or more-so that they have been victims. By looking to recover the excess bad debt from those customers, who have continued to trade and pay, despite them being part of the most affected segment of the economy, this would seem to us potentially unjust and likely not to be accepted. This would increase the likelihood of challenge from customers as to their assigned category and associated additional charges. By focussing recovery on individual groups of customers the bill impact will also be amplified, whereas spreading across the entire customer base would better diluting the effect of the recovery on charges to what may be a more negligible increase.

Overall we see many reasons for recovery of excess bad debt costs from across the entire non-household customer base, rather than specific groups. For these reasons we would not support targeted allocation of recovery from any particular customer group.

Regional versus national

A regional approach, where debt is attributed specifically to each region, may be unnecessarily complex to administer, and likely to cause additional unnecessary delays, which should be avoided.

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 are not responding to this question.