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Dear Ofwat,

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

Thank you for providing us an opportunity to respond to the call for inputs on Covid-19 and the business retail market in respect of bad debts. We are eager to discuss our thoughts on the revisions to the regulatory framework that we believe will be required to address the elevated customer bad debt costs resulting from the pandemic.

Please find our response to each of the fourteen associated CFI questions in detail within appendix 1 below. We broadly agree with the well-intended principles set out within the consultation, however within our response we have expressed particular concerns about:

- The measurement of bad debt for the purposes of any future recovery
- The mechanics of recovery: keep bad debt risk and costs low
- The urgency of certainty and support
- How to bridge the gap between a customer not paying today and recovery in c.2-3 years' time.

Our response includes a consideration of both approaches to recovery identified within the consultation document, however at this stage we are minded that neither approach would ultimately be suitable as the solution to this issue. Our preliminary discussions with other market participants have highlighted that our reservations are shared with others in the market. Whilst these discussions have not yet led to a Retailer consensus on an appropriate option, we have endeavoured to provide the outline of two alternative recovery mechanisms (one preferred) which we believe can be further developed to present an effective market solution.

We would be more than happy to discuss these points in more detail, so please do not hesitate to contact me or someone from the Legal and Regulation team (contact details below or simply [redacted]).

Yours sincerely,

[redacted]

Lewis Gross
Chief Financial Officer
[redacted]

Appendix 1

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 agree that customer bad debt costs should be measured solely in terms of amounts due from customers that are appropriately provided for or written off.

While we agree that '2) working capital costs' (as referenced on page 8 of the CFI) should be excluded from this exercise, we disagree with the reasons for excluding it. The working capital relief extended to Retailers in the form of wholesale charge deferrals was at an interest rate far above market rate and outside of their available margin. The situation was made worse by the changes to the Customer Protection Code of Practice preventing Retailers from recovering any of the expense from customers. However, we can see why, for the avoidance of confusion, this matter should be considered separately.

Regarding the exclusion of '3) debt recovery costs' (as referenced on page 8 of the CFI), we agree with Ofwat.

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 costs may have differed by region and/or customer type, but we do not believe these factors should be considered specifically in the bad debt cap and recovery mechanism.

Geographic region and customer type are relevant to each Retailer's bad debt provisioning methodology and, amongst other factors, will be used in determining the propensity to default of a customer. However, we do not believe these factors are relevant to Ofwat's decisions about the recovery mechanism for two reasons:

1) In assessing the appropriate amount of excess bad debt: attempts to second-guess the extent to which Covid-19 has affected each area and industry could prove to be wildly inaccurate once the final impact of the virus is known; and

2) In determining the best way to apportion the additional cost of bad debt to customers: we believe that attempts to recover excess bad debt costs from the remaining customers in the worst affected regions or industries could exacerbate bad debt risk from remaining customers in these areas.

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 believe the approach to measuring bad debt costs arising should be rules based, rather than principles based. By this we mean that Retailers should be given a set of criteria that must apply to a debt balance for it to qualify to be included in the recovery mechanism. For instance, the criteria might be: billing raised on specific dates to specific customers that have either been written off or have reached a specific age.

If debt that qualifies for inclusion in the mechanism is subsequently collected, this should not cause a problem as good record keeping will mean details of these debts are visible and can be included in a "true-up", if necessary, in the following year.

We would then expect for the approach and criteria of the scheme to be audited.

On this basis Retailers would re-baseline their starting point. Currently bad debt charges contain a large element of estimation and there are different rules depending on the accounting standard adopted by each Retailer. Retailers using FRS102 ("UK GAAP"), where bad debt is only recognised when a customer has defaulted, or those Retailers with little observable history of customer behaviour on bad debts may have low baselines and will benefit disproportionately Compared to Retailers reporting under international accounting standards (IFRS) who have to recognise bad debt on an "Expected Credit Loss" (ECL) basis, which results in higher bad debt charges. Setting criteria for measuring bad debt on an objective basis will help ensure the baseline is as fair and equitable between Retailers as possible.

Once the threshold is set, all Retailers should track progress of collections and write offs of their qualifying aged debt. This should be done using a pre-defined template common to all Retailers, in a similar vein to the wholesale deferral template. This would then be populated by all qualifying Retailers and submitted regularly to Ofwat/MOSL to keep track of the scheme. While presenting an administrative burden to Retailers and to Ofwat/MOSL, this system would be simple, transparent and comparable, which should minimise the overall burden of administration of the scheme in the long run.

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 disagree that Retailers should be allowed to determine the basis on which they report bad debt costs because there is too much variability in reported amounts (see response above to question 3). We believe that Ofwat should set out a more prescriptive and defined basis that will eliminate the impact of different bad debt provisioning methodology and differences in collection practices across Retailers.

A prescriptive approach will help with administration of the scheme, ensuring all Retailers can be compared accurately and audited easily. It will also make sure the scheme is fair with regards to total amount recovered, and ensures Retailer outcomes are appropriate to their customer interests.

The non-statutory basis outlined on p14 could be a good starting point for establishing an objective, non-statutory basis that will be fair across all Retailers.

If Retailers were to use their own bad debt provision rates from their statutory accounts, there will be large discrepancies between Retailers that would not be consistently reflective of excess bad debt exposure.

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?

Bad debt costs can take a long time, potentially several years, to materialise due to the nature of water supply and difficulties in identifying and cutting off customers. Our policy as a business is that we do not write off individual bills for a customer, we would only write off debt on an account level in the event of a business failure or where we can no longer trace the customer.

If a customer disputes a bill because the charges are wrong, we will investigate and credit note/re-rebill charges for that period. We would never in the ordinary course of business write off a genuine, valid water bill and then continue to supply a customer. Doing so would set a dangerous precedent and could lead to cross subsidisation of customers. It would also be onerously costly for the business. For each bill unpaid approximately 12 other equivalently sized bills need to be paid to recover the loss (assuming c8% average gross margins).

It is also difficult to prevent supply to a customer that has not paid. It can take a number of months to obtain sufficient evidence to disconnect a customer and write off the balance. This long process will only commence, when Retailers become aware of a non-payment issue. Given some customers are billed quarterly, it will be approx. 4 months before there is the first sign of late payment. The debt chase steps will then commence for a number of months, during which for all of this time there will be continued fixed charges building up and any consumption.

Additionally, the full impact of Covid-19 (‘**Covid’**) is still not known. It remains to be seen how many customers are still trading only due to the existence of Government support but will be unable to continue when this support has been withdrawn, meaning increased excess bad debt from Covid could still materialise throughout 2021.

For these reasons; the unique nature of water retail versus text-book accounting bad debt, and the uncertainty that still exists around the true impact of Covid, we believe Ofwat should consider customer debt covered by these three criteria:

1. Customers with debt arising prior to the start of national lockdown in March 2020 but who had not paid by the time lockdown began. A proportion of these customers would have paid once debt collection activity was undertaken, but will now cease trading before the debt can be recovered;
2. Bills raised during lockdowns, which were affected by a customers’ reduced ability to pay and compounded by the Retailer being unable to pursue debt collection activity; and
3. Debt raised after the lockdowns from customers that will delay payment and go bankrupt once government support ceases.

In order to account for all three categories, we would recommend a commencement period at least six months (Oct 2019) and preferably 12 months (Apr 2019) before the start of the first national lockdown, with bad debt arising from billing being eligible until such time as significant regional restrictions cease. If more debt is collected than expected, or more customers go bankrupt subsequently, this can be picked up in a true up at a later date.

Historically, we have recovered payments from customers who have not paid for more than two and even three years, so it should not be assumed that older debt is uncollectable. Provided the customers continue to be in business it can be collected.

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.

In April when we performed our first Covid-influenced debt assessment, we concluded that Covid would increase bad debt by a multiple of 2.5, from an underlying rate of approx.1% of revenue to approx.3% of revenue. Whilst it is still too early to know the impact, there are indicators suggesting the bad debt will materialise over time:

[Redacted]

These indicators suggest there is a significant number of customers in distress, which is corroborated by anecdotal evidence from discussions held with customers. The combination of additional customer likelihood of default combined with higher debt balances significantly increase bad debt risk, so we believe that a 2 – 3 times uplift in bad debt is still possible.

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 do not agree that these are the right objectives for considering whether and how to amend regulatory protections in relation to bad debt costs. Whilst these objectives are broadly aligned with Ofwat's statutory obligations and the interests of the market, we are concerned that they do not adequately address the existing risks to Retailers and therefore customers.

Building on the existing objectives, we have identified the following areas that should be included in the assessment process for related amendments to regulatory protection:

Clear need for expedient clarity and decision making – As previously identified, in particular at the associated 'webinar' on the 11th of January 2021, there is a clear and pressing need for decisions to be made as soon as possible. Retailers are already in a weakened position as a result of the on-going pandemic and this exposure looks set to continue to increase as the implementation of any mechanism is likely to have some period of lag involved (for example charge-affecting changes will not be able to be implemented until April 2022). Retailers need clarity on these actions urgently for the benefit of their customers.

Protection from additional cash flow pressures - Impacted Retailers should not be made worse off as a result of any regulatory change, and the initial proposals mused within the consultation document highlight a risk that a new mechanism may create additional cost pressures or capital requirements in the short term. Effective regulatory change will require understanding of the poor cash flow position within the market and limited additional capacity in the short term.

Fair and Proportionate treatment of Retailers – Any changes to regulatory protections should be aligned to actual (and auditable) additional bad debt exposure. Proposals (i.e. increases to charging and levels of redistribution) should have a factual accounting basis and unaffected Retailers or new entrants should not receive unjust benefit at the cost of customers as a result of any change. Any such policy should not create market "winners" and "losers", and the solution should not cause further market distortion at the cost of the customer.

A long-term enduring solution – Whilst the case for urgency in decision making is clear and necessary, as stated earlier the true and final impacts of the on-going pandemic on the bad debt position will not materialise for a number of years. Any approach to recover these costs should include an on-going mechanism to allow for further 'true-ups' in future years as the final position becomes clear.

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?

Water Plus does not support the use of amendments to the REC as a method to recoup (some portion of) excess bad debt costs. Whilst mechanically this represents a simpler option to deliver in the market, there are severe challenges with this method that would undermine the effectiveness of this approach as a solution for the excess bad debt issue.

The use of the REC to recover additional bad debt costs would enable Retailers to increase the level of charges they apply to their customer through increases to their allowed retail margin. This retail margin represents the 'contestable' element of the customer's bill and increases to this charge will enable other Retailers within the market to step in and contract these customers. Whilst increased competition is typically a signifier of market health, in this instance it would represent a further shift of revenue away from affected Retailers and would soon be eroded away from the market by competitive tendering meaning the price uplift may not ever recover the additional bad debt already incurred. Without additional corrective mechanisms to account for the existing impact, the competitive forces present within the market threaten to mitigate the effectiveness of this solution.

When considering practical implementation at a high level there are two routes that might be taken, each of which shows significant weakness and we believe should be considered undesirable:

- **Increase in all default tariffs within each area** (most likely) – This approach would look closer to an outright margin injection, which would in no way distinguish between affected and unaffected Retailers. Whilst independently there is a case to be made for margin injection in the industry, this cannot be considered as an effective solution for the bad debt issue as largely unaffected Retailers will still see a similar increase to their revenues without a need to recover cost, at the expense of the customer.

- **Increase the default tariffs within each area for each specific Retailer individually** (Whilst possible, this is not aligned to how the Retail Exit Code is currently written) – Whilst establishing separate default tariff caps for individual Retailers will ensure that less affected Retailers do not experience supernormal margins from their existing customers, such an approach would not only be highly complex to deliver but would also have considerable distortive impacts on the competitiveness of the individual Retailers within the market.

Whilst we do not consider amendments to the REC as the appropriate mechanism for addressing the issue of excess bad debt, we would separately urge Ofwat to review the adequacy of the pricing restrictions contained within these regulations.

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

Whilst we believe there are a number of significant challenges related to the use of increased (in the short term) wholesale charges as a corrective mechanism in the market, this approach represents a more appropriate and equitable method to recoup (some portion of) excess bad debt costs when compared to the REC approach.

By ensuring that increases to charging are not tied directly to the contestable retail margin, the distortive impact on market competition is removed and Retailers will be able to continue to compete on normal terms whilst in the knowledge that the bad debt issue will continue to be tackled across the market as a whole. Additionally, such an approach will more effectively distribute the impact of Covid-19 on bad debt across the customer base and the use of a centralised entity to redistribute these collected funds will ensure that any additional recovery is adequately and proportionally aligned to exposure witnessed.

In order to ensure that this approach appropriately protects the market and customers, we would ask Ofwat to consider the impact of additional wholesale charging on the capital requirement of individual Retailers. Whilst wholesale charges are passed through in their entirety to the customer base eventually, this timescale of charge recovery from customers is significantly lagged compared to when these charges fall due from the wholesaler. Increases in the level of wholesale charges due through settlements will likely lead to not only additional bad debt exposure from customers for non-payment but will also require additional levels of borrowing to meet the short- term obligations to Wholesalers.

The use of additional wholesale charges is a preferential option than the REC approach in addressing the recovery of excess bad debt costs but the impact on Retailer cash flow must be considered.
This includes consideration of the following three points for Retailers:

1. Having to recover the excess bad debt via the wholesaler adds additional delay to the process when support is required urgently.
2. Additional wholesale charges increase the risk of additional bad debt and working capital strain on Retailers
3. Adding in another party into the mechanism will bring additional administrative burden and cost.

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 identified in the response to question 9, an increase to wholesale charges will result in higher costs of capital and an increase in bad debt exposure for Retailers. In addition, the process of completing and auditing a potential application process may lead to some additional costs. We would, however, expect that careful consideration of what is possible for Retailers to complete, in addition to clearly specified application requirements, would mitigate this additional cost.

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.

Yes, we believe there are alternative approaches that should be considered that avoid the flaws identified in the method above and could be used to deliver timely and cost effective bad debt relief without creating additional risk or unjustifiable distortion in the market.

In particular, we would urge Ofwat to consider an approach that enables Retailers to calculate their excess bad debt exposure and submit this as a credit note to their Wholesalers.

1. In line with the existing Retail Exit Code option, Retailers should calculate their total eligibility for debt relief and calculate this excess bad debt.
2. As per the Wholesale Charge increase option, this excess bad debt should then be attributed within each wholesale area (mechanism to be agreed, a simple approach could be pro-rata to average monthly wholesale charging).
3. Once these amounts have been calculated and confirmed (by audit) Retailers should be able to submit this amount as a credit note request to the relevant wholesaler.
4. Upon receipt of the credit note requests, Wholesalers should grant an immediate reduction against the respective Retailers next wholesale charging invoice.
5. Wholesalers would then be able to utilise existing market mechanisms, such as the Revenue Forecasting Incentive Mechanism, to subsequently recover this short term reduction in revenues in future price setting.

We believe that this would be most the beneficial option to the market as it utilises the extensive liquidity Wholesalers* are already required to hold as a national utility infrastructure provider to ensure the support the market requires. This approach would deliver immediate and significant relief to Retailers, without an increase in working capital that would be required with any approach that require Retailers to pay additional wholesale charges in advance of recovering the increased bill amounts from their customer base (counter-intuitive to extend working capital requirements as a way to receive immediate liquidity support). Additionally, the delay in passing increased wholesale charges onto customers will not put further pressure on already stressed customer finances.

*Whilst the level of excess bad debt is yet unknown, it is highly likely to be a small percentage of total wholesale revenues and therefore adding very little additional risk to Wholesalers and the market as a whole.

We would strongly urge Ofwat therefore to consider this option as it best fits the needs of our customers (delayed impact on increased bills), Retailers (provision of earlier liquidity support by recovery of a share of excess bad debts) and reduces any wholesale administration burden (by using the existing Revenue Forecasting Incentive Mechanism for revenue recovery.)

Should Ofwat not concur with our preferred option stated above, however, we have additionally provided another alternative below that slightly compromises on these advantages.

This option would be to introduce an additional charging element that would be collected by the Retailer as a levy to recover their excess bad debt costs. Insofar as amounts collected by the retailer were under the total allowed excess bad debt assigned to that Retailer, the retailer would keep all amounts recovered. Any amounts collected in excess of the Retailer's allowed bad debt recovery would be remitted to a third party who would administer the scheme and reallocate any excess to Retailers that had under-recovered. Any excess recovery in totality would be returned to customers in the following year or used to pay for administration of the scheme. We feel this meets the requirements of a successful recovery mechanism outlines in the responses above:

1. Timeliness – in the most part, Retailers would receive relief at the point a customer pays. Any delays caused by passing funds through third parties would be minimised.
2. Competitiveness – the levy charging element could not be competed away so would be unfairly prejudice any one type of retailer, not prevent active trading in the market.
3. Simple – cash flows between parties would be kept to a minimum. Once cash was collected from a customer, further cash remittances would occur in the exception that there has been a material over or under-recovery
4. Low risk to distressed Retailers – by providing the relief directly to the Retailer rather than passing the relief to the wholesaler in the first instance, no additional working capital burden is placed on Retailers, nor is the loss in the event of default increased by incurring additional wholesale charges on the Retailer. If the customer defaults, only the standard wholesale charge is lost.
5. Low risk of scheme failure – As the levy charging component cannot be eroded through competition, the risk of under-recovering bad debt charges due to the additional margin being competed away is removed.
6. Low administration burden – while the scheme will need a third party for administration, Wholesalers do not need to be involved, and cash flows between parties will only happen on an exceptional basis.

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 welcome the acknowledgement by Ofwat that excess bad debt is adversely impacting the market and the proposals made by Ofwat to allow Retailers to recover an element of bad debt. However, we are concerned that the timescales of recovery are detrimental and insufficient to alleviate the current market problems.

Bad debt charges are the result of customers not paying and it is this immediate liquidity concern (i.e. the absence of cash) due to customers not paying their bills when due that is causing the greatest hardship. In turn, this places non-defaulting customers at risk who are making payments in good faith at risk, including the risk of systemic Retailer failure. If there was a way to provide liquidity relief in the shorter term, which is then funded by the recovery of excess from bad debt from customers, this would be far more effective for protecting against this risk.

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?

By the very nature of bad debt, it will not be possible to account for the increases to bad debt exposure directly from the customers who have led to the increase in additional bad debt costs. As such, any approach undertaken will to some degree involve the pooling of costs amongst different customer profiles.

We consider this 'pooling' of recovery across the market as justified, as the risk of systemic retail failure is a market-wide risk that will ultimately affect all customers. The protection afforded by such 'pooling' will benefit all customers in the market.

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 once bad debt has already exceeded the 2% threshold of turnover, Retailers have already incurred a material share of the impact of the on-going bad debt issue. Asking Retailers to take on an additional share of these costs will be detrimental to the interests of the customer as it places the Non-Household Retail Market at further risk.

As a result, we would strongly recommend that no additional bad debt costs are placed on the Retailer. We would encourage Ofwat to consider alternative options, including sharing the burden with the Wholesalers (with a view to available capacity.) As an example, this could be included as an addition to our preferred option in response to question 11 above.