Introduction

Wave welcomes the opportunity to contribute to the thinking around how the industry best addresses these difficult issues.

In essence, we do not believe it is feasible for Ofwat to attempt to capture the entire cost of the Covid pandemic prior to agreeing a relief mechanism, due to the necessity to begin to address the issue quickly. By its nature, assessing true bad debt costs will always take many months if not years, and whilst the accounting approach we support below will give a much earlier indication, it is clear that the pandemic itself cannot easily be ringfenced for quantification. With the introduction in January of the third lockdown, lasting at least 6 weeks minimum, it is clear that the cost of the pandemic is ongoing. Retailers cannot continue to remain viable businesses without urgent support for cashflow and profitability to mitigate the working capital pressure and satisfy banking covenants. The situation has been made worse, because the cost allowances for working capital incorporated within the Retail Price Controls at PR16 were grossly underestimated. Wave requests that bad debt cost recovery should start from 1 April 2021.

We have set out Wave's views on the questions posed as follows:

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?*

   Wave recommends quantification of the total increase in customer bad debt costs due to Covid, including Retailer financing costs.

   The pandemic has hugely impacted our customers' ability to pay their bills, not just bills that have been issued since March 2020, but bills that had been issued earlier but remained unpaid (as many customers are unfortunately slow payers). Retailers will have a payment curve showing that collectability reduces as the debt gets older, but there will still be some collection success even on older debt. As customers have been impacted by Covid they had difficulty paying, regardless of the age of outstanding debt, and consequently these older debts will have aged further. The extent to which the collection of aged debt has changed between pre and post-Covid is therefore just as relevant as for younger debt.

   The way in which Wave monitors bad debt is to maintain a provision for all debtors regardless of when a bill is issued. The provision is increased or decreased to reflect the risk of non-recovery depending upon risk factors of the outstanding debt, such as whether a customer's business remains open or has closed. With a provision approach, older debt will already be more heavily provided for. Any deterioration in this aged provision since the start of the pandemic can be easily quantified. Therefore, we believe strongly that excluding bills issued pre-January 2020 from the period of which bad debt costs should be measured is inappropriate.

Whilst the deferral of wholesale payments has been helpful in preventing Retailers from running out of cash whilst other funding arrangements were put in place, that support has been charged at 6% to incentivise development of alternative arrangements and early repayment. Outside of the wholesale charge deferral scheme, Retailers are facing significant additional financing costs of increasing working capital arising from slower customer payments but regular monthly wholesale charges being due.

The chart below shows the difference between 2019 and 2020 with respect to working capital and debtor days.

The chart shows an increase in working capital and debtor days in March 2020 into April and through to July, despite the reduction in billing values as a result of the temporary vacant scheme. When the temporary vacant scheme came to an end and billing resumed, working capital and debtor days increased significantly from August to November. Between March and December, the average working capital increase is £[redacted], driving significant additional interest costs. Therefore, the evidence demonstrates that Ofwat should also have regard to the impact of additional financing costs of additional working capital on Retailers.

Early indications from January 2021 (lockdown 3) are that cash collection figures have dropped c.[redacted]% since the November/December 2020 run rate. We therefore expect working capital and bad debt costs to increase significantly in early 2021.

The proposed timescale of April 2022 for the start of any bad debt cost recovery means that Retailers would have to continue to carry the cost of unrecovered debt, potentially for more than 2 years before any recovery. This means that the ‘excess bad debt’ needs to continue being funded for that period until it can be recovered which is not sustainable. It is therefore imperative that the cost recovery mechanism begins as soon as possible, effective from 1st April 2021.

This situation has been made considerably worse for Retailers because the cost allowances for working capital incorporated within the Retail Price Controls at PR16 were grossly underestimated. The data available at the time of setting retail price controls was naturally based on cost allocations and assumptions made by the integrated water companies at the time. Wave’s average annual bill for smaller customers (i.e. less than 500m^3 annually) is c.£800 with an allowed cost of £76, which has needed to cover our historic [redacted]% SME specific bad debt cost (£[redacted]). In the 12 months to December 2020, we have seen overall debt costs increase from [redacted]% to [redacted]% (see table on page 7), with our SME specific bad debt cost increasing from [redacted]% to [redacted]%. This equates to a £[redacted] increase in debt costs, which is greater than the retail default margin for this segment of customers, indicating the entire segment is, on average, loss making.

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

Wave expects to see regional and customer type variances in bad debt impact, in line with regional variances of Covid impact, the application of the Government tiering system including non-essential business closures.

It seems likely that bad debt costs will differ by geography or customer type depending upon the severity of impact of lockdowns and restrictions on customers' businesses.

Government statistics provide clear evidence that there has been a regional impact of Covid in recent months, resulting in the introduction of a regional tiering system. The North East was one of the first areas to enter a local lockdown in advance of tiering and remained in tier 3 until lockdown 3. Tier 4 areas essentially re-entered a state of full lockdown, with the closure of all leisure and non-essential retail businesses. The impact on local businesses has therefore been much higher in these areas compared to areas where infection rates initially remained low (e.g. Cornwall). Equally the impact on entertainment, leisure and hospitality has been much more significant than on agricultural or larger industrial.

In addition, SME customers have been hardest hit by Covid and the forced closures and pose the biggest concern. We fully expect to see a much higher impact on smaller customers with less resilience to financial shocks and higher insolvency and vacancy rates than larger businesses. Despite the Covid Vacant Scheme running throughout the first lockdown and therefore greatly reducing billed value, SME debt has increased by [redacted]% from pre-Covid (December 2020), with associated provision increasing by [redacted]% in the same period. This is reflected in the deterioration of the health of the SME debt book, with the value of debt that is aged increasing by [redacted]%, indicating a significant affordability issue across the SME business population.

Early indications in lockdown 3 are that whilst we are seeing similar issues with the larger I&C customers as during the first lockdown, the reduction in cash collections from our SME customer groups again has been much more severe, highlighting fears that customers (as well as Retailers) have entered this latest period of restrictions with significantly less financial resilience than during 2020.

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

   Wave recommends using standard accounting approach to measuring the total increase in bad debt costs due to Covid.

   Standard accounting practice / IFRS9 already sets out an approach to measure bad debt costs, so we would advocate using the same established approach, which is already objective, consistent and verifiable.

   The approach requires an assessment of risk across the whole debt book, not just aged debt, for the purposes of calculating an appropriate bad debt provision. Wave achieves this by assessing the age and characteristics (customer segment and account status) and applying a set of provision rates based on the historic evidence and collectability of those age and customer characteristics. Whilst the characteristics of ageing and account status can be recognised immediately, the collectability of those factors (and therefore the provision rates applied) take longer to assess and update because it is based on actual performance. However, over time it provides a very robust evidence-based assessment of the future bad debt risk inherent in the portfolio in a manner consistent with the requirements of IFRS9. As a result of this or a similar approach, Retailers should be able to clearly evidence the significant impact on collection rates since the start of the pandemic, and therefore the extent to which bad debt cost has increased. This is fully audited through usual accounting practices and requirements.

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.

Wave agrees that Retailers should determine the basis on which they report bad debt costs in accordance with relevant accounting standards and audited accounts.

The common factor is that it must be independently audited to meet clear and pre-prescribed requirements, but it has the advantage of leaving Retailers with some flexibility based on systems and information available. Our understanding is that the 1% benchmark, identified by Ofwat in its April 2020 consultation, was based on the average level of bad and doubtful debt over 2018/19 and 2019/20 which we presume was derived from Retailer published accounts. If our presumption is correct, then this approach is consistent with how the 1% benchmark was set and can be evidenced retrospectively to assess a clear track record. Any mechanism based on this would be providing relief against the costs the Retailer has had to recognise, therefore provides mitigation proportionally.

It's not clear how the other alternative mechanism would match costs recognised. The level of bad debt exposure and provision required will always require a significant level of scrutiny by auditors, as it is and always will be one of the key risks to a Retailer's business model. We support using an existing and well understood mechanism, rather than to attempt to develop something new and independent to assess Retailer's bad debt risk, which may introduce unintended consequences and significantly add to the burden on already stretched teams. Whilst a key test is the adequacy of the bad debt provision, auditors are equally required to assess the P&L for understatements (e.g. a deliberate overprovision). This should provide comfort against the suggested risk of over-estimation. In addition, a Retailer's auditor is required to have the experience and expertise to assess the adequacy of the bad debt provision and are therefore best placed to carry out this function.

5. *(a) What is your view on the period over which we should be measuring bad debt costs arising?*

The period of measurement should cover accounting periods including any 'Covid affected months', being months between and including January 2020 and 6 months after all restrictions have finally been lifted – a date yet to be determined.

Periods that should be included are:

- Accounting periods from and including January 2020 –auditors require comfort on the recoverability of the debt book before they sign-off statutory accounts. Any January 2020 accounts are unlikely to have been signed prior to the start of the pandemic in March 2020 and would therefore need to reflect the lower expected collectability of the debt book at the point of signing the accounts, and therefore include additional cost directly attributable to the pandemic.
- Accounting periods including months where lockdown measures were still in place - if tiered restrictions get lifted during March 2021, an accounting year ending in December 2021 would still be impacted, with inflated debt costs reported in that period.
- Accounting periods including months up to 6 months after all restrictions lifted – it is clear that the economic impact on businesses has a very long tail, and that only once all restrictions have been lifted will some businesses be able to assess viability of their businesses. We expect heightened levels of insolvency not just during periods of Government restrictions but for some months thereafter.

The extension of restrictions into 2021 provides clear evidence that it is pointless to set a specific time limit without relating the period to the restrictions in force.

Starting from April 2020 is inappropriate. The incremental bad debt costs arising from the pandemic have been primarily caused by the combination of the Government response (lockdown restrictions driving lower trade) and the resulting stressing of businesses' financial resilience. The bad debt issue has not been caused by regulatory interventions to cease collection escalations. These 'Covid measures' were introduced as a protection for customers in this time of difficulty, and have exacerbated the situation for Retailers, but were not the trigger, therefore the timing of the implementation of these measures is not relevant. Our evidence clearly shows a deterioration in cash collected from mid-March (see graph provided under question 6), when the lockdown started, and depressed collections continued well beyond the lifting of those initial restrictions. Most importantly, the provision takes a view on the future collection of the current debt book based on all available information, meaning we had to demonstrate an appropriate provision against the March 2020 debtor to reflect the impact we expected lockdown to have on the invoices already issued at March 2020.

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

Wave suggests the interval after the period of impact will already be implicit in the time required to finalise and sign audited accounts, and therefore no further delay or interval is required, once those accounts are available. Any impacts confirmed by published audited accounts can be considered, with subsequently published Retailers' accounts considered in the next period of review. Wave believes Retailer funding implications also need to be considered.

Whilst relying on statutory accounts provides the assurance of an independent audit, we do not believe it is necessary to then wait a further 6 months, or to revisit historic accounts for a separate true-up, as this will happen by default in subsequent accounts. Instead we believe that once statutory accounts are finalised, they should be immediately eligible to be used for this purpose.

In signing the accounts, particularly during this period of uncertainty, auditors will generally require a time following the period end to assess the adequacy of any debt provision, specifically based on evidence of subsequent cash collection and write-offs. There is normally a 9-month window within which accounts must be submitted to Companies House for this very reason (although note this has temporarily been extended to 12 months due to the pandemic). We therefore strongly believe that by the time the accounts are audited, agreed and signed-off, there has already been an implicit verification of the adequacy of the provision.

In subsequent periods, if the provision turns out to be insufficient or overly prudent, the impact of any adjustments would be reflected in the following statutory accounts, which are again independently audited. We therefore believe that rather than a separate 'true-up' exercise on a set of financial accounts, review of the subsequent accounts will give Ofwat this assurance over any misstatements.

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.*

Wave currently forecasts an increase of bad debt cost between [redacted]% and [redacted]% compared to a baseline cost in December 2019.

We fundamentally disagree with the baseline for comparison being March 2020, for the reasons explained above. As outlined, the 'costs' are recognised when the view of collectability changes, and for Wave, a key milestone of change was the start of the lockdown in mid-March:

- **Cash –** Wave experienced a [redacted]% reduction in daily cash collected in March, triggered in the latter part of the month, as advised in our response to a previous consultation:

- **Direct Debits -** We also previously highlighted the spike in cancelled direct debits seen from mid-March, again indicating the impact in March:

In terms of the scale of bad debt costs arising since the start of the pandemic:

- Specifically, for insolvencies already identified, the monthly cost of insolvent debt between September 2019 and February 2020 was £[redacted] per month. Between February and November 2020, this rose to £[redacted] per month, almost tripling the level of write-offs required. In December 2020, this jumped again to £[redacted] recognised in one month. Independent economic commentary points to the level of insolvencies continuing to rise as we head into 2021.

- Wave uses roll rates to track the value of debt 'rolling' from one aged debt timeframe to another. It provides useful analysis over collection performance and helps to inform the level of debt risk and therefore provision. For SME Live Debt (accounts still on supply), there has been a [redacted]% increase in the uncollected debt by the time the debt reaches 6 months old, and for SME Final Debt, this increases to a [redacted]% rise. The chart below outlines this deterioration:

- Wave, like other Retailers with a March year end, was required to significantly increase its bad debt provision in the March 2020 accounts to reflect the impact of the pandemic on the debt book at 31 March 2020. This £[redacted] increase was included in the previous RFI. Wave does not recognise the statement made in the Webinar Summary issued by Ofwat on 19 January that "information and data available to Ofwat at present …..... do not give a clear indication that bad debt costs to industry increased significantly to June 2020".

- Wave's current bad debt provision (which is now based on the roll rates above) indicates an increase in the bad debt risk from our pre-Covid run rate of just [redacted]% to [redacted]% for April-December 2020. Including the £[redacted] incremental provision booked in March 2020, the bad debt cost for the 10 months since the start of the pandemic in March 2020 equates to [redacted]%.

- We would also like to highlight the severe reduction we have so far evidenced in January 2021, being a c.[redacted]% reduction in daily cash from £[redacted] per day in November and December to just £[redacted] in the first 10 days:

  The abruptness and scale of this reduction surpasses the impact seen in lockdown 1.

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?*

   Wave believes Retailer funding implications also need to be considered.

   We largely agree, however we believe the interpretation of "1. Protect customers' interests" is expressed too narrowly. Whilst reference is made to Retailer failure, it should be recognised that the risks inherent in the market need to be balanced with potential returns in order to secure funding and therefore achieve the position of an "adequately financed business".

   This issue has been extremely evident through our discussions with our banks in recent months. The process to secure a Government-backed support loan, offered in direct response to the issues caused by the pandemic, has been extremely arduous and drawn out and highlights the issues evident in securing finance for a Retailer in the current market. Once a scheme was available that Wave was eligible for, discussions started immediately with our banks in May 2020. However, it took almost 5 months, plus significant additional security from our shareholders to secure additional funding. The forecasts underpinning this loan needed to assume some level of bad debt recovery from April 2021 therefore the indication that any such recovery could be delayed to April 2022 will adversely impact Wave's ability to meet the financial covenants implicit in this loan agreement.

   It is clear how difficult it is for investors to provide 100% funding for these businesses with the current balance of risk and reward, particularly given the much higher levels of working capital required. Consideration needs to be given not just to equity returns, but also to whether the business model is 'financeable' by third party lenders in light of risk and returns.

   [redacted]

   [redacted]

[redacted]

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?*

Wave believes that an increase in all retail tariffs by all Retailers in the form of a 'retail levy' is the simplest and most effective mechanism for recouping excess bad debt costs.

We think that instead of an amendment to the REC to permit an increase in retail tariffs via a relaxation the price controls, it would be preferable to have a separately identified charge or 'retail levy' which would be recovered from all customers. In order to size the 'retail levy' an audited value of incremental bad debt costs would be required by each Retailer and the total value converted into a £/day fixed charge across the NHH customer base that all Retailers would charge and recover from all their customers. The 'retail levy' recovered would be monitored and audited and each year could be adjusted as appropriate. The scheme would be administered by a central body such as MOSL and the costs of auditing the scheme added into the 'retail levy' and recovered from customers. If the costs are left solely to Retailers, it only serves to dilute further the ability to recover the historic excess cost.

The benefits of this approach are:

- It is more straightforward and therefore expected be more cost effective than a scheme which involves recovery through wholesale charges supported by a centrally administered scheme.
- It would be quick to implement (through an amendment to the REC to permit the 'retail levy' to be charged) and therefore could be effective from 1 April 2021.
- It is flexible and can be easily adjusted as appropriate.
- It ensures a level playing field between Retailers including those supplying mainly non-contracted customers (subject to the REC price controls) and those with mainly contracted customers.
- It ensures a level playing field between Retailers already in the market and potential Retailers who might seek to enter the market.
- Because the fixed charge will be a slightly greater proportion of a smaller bill therefore there will be some weighting towards SME customers, which are primarily driving the bad debt costs.

To adopt an approach which only amends the REC to permit an increase in retail tariffs via a relaxation of the retail price controls, will not enable Retailer recovery of the debt. This is because the retail price controls do not apply to all customers (i.e. those who have negotiated contracts). This approach would make some Retailers uncompetitive (because of the need to increase tariffs to recover the debt cost) whilst presenting new entrants and Retailers solely with negotiated tariffs, with an opportunity to under-price. Care is needed to ensure that a mechanism aimed to recover the additional costs of bad debt arising from Covid does not create a competitive advantage for some Retailers.

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

Wave does not consider recouping excess bad debt costs through wholesale charges to be the best option.

We had previously considered that recovery through wholesale charges might be the best option. However, whilst this is preferable to a simple amendment of the default retail tariffs via the REC, our thinking has developed further, and we now consider a 'retail levy' to be less complex and less costly to implement.

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?*

    Wave does not consider recouping excess bad debt costs through wholesale charges to be the best option.

    We consider that this option is likely to be more costly and complex to administer.

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.*

    Wave believes that an increase in all retail tariffs by all Retailers in the form of a 'retail levy' is the simplest and most effective mechanism for recouping excess bad debt costs.

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

    Wave believes the Covid-affected period should commence in January 2020 and end 6 months after all restrictions have finally been lifted (yet to be determined).

    We believe there is significant evidence already in the market (Wave, WaterPlus and Pennon have all filed accounts as at January 2021) to support excess costs already incurred to March 2020, together with information submitted in the July RFI (which for Wave included the significant additional costs recognised in March 2020).

    Once a Retailer has filed its accounts to demonstrate excess bad debt costs then it can participate in the process of recovering a 'retail levy'. For some Retailers that will enable recovery effective from 1 April 2021, for others it may be later in 2021.

    Under the 'retail levy' mechanism, once the costs eligible for recovery are locked in and added to bills, there is nothing to stop a disbursement of those costs on a monthly basis if they are collected and administered centrally. Our expectation is that this mechanism could commence in April 2021.

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?*

    Wave considers that recovery of excess bad debt costs should be pooled across customer groups and/or regions.

The danger with targeting those customer groups who have driven the exposure with the incremental charges (e.g. hardest hit geographical regions, or smaller customers), is that the premium is charged to the portion of the market that has suffered the biggest impact from the pandemic, meaning higher price rises for those customers who have been hardest hit.

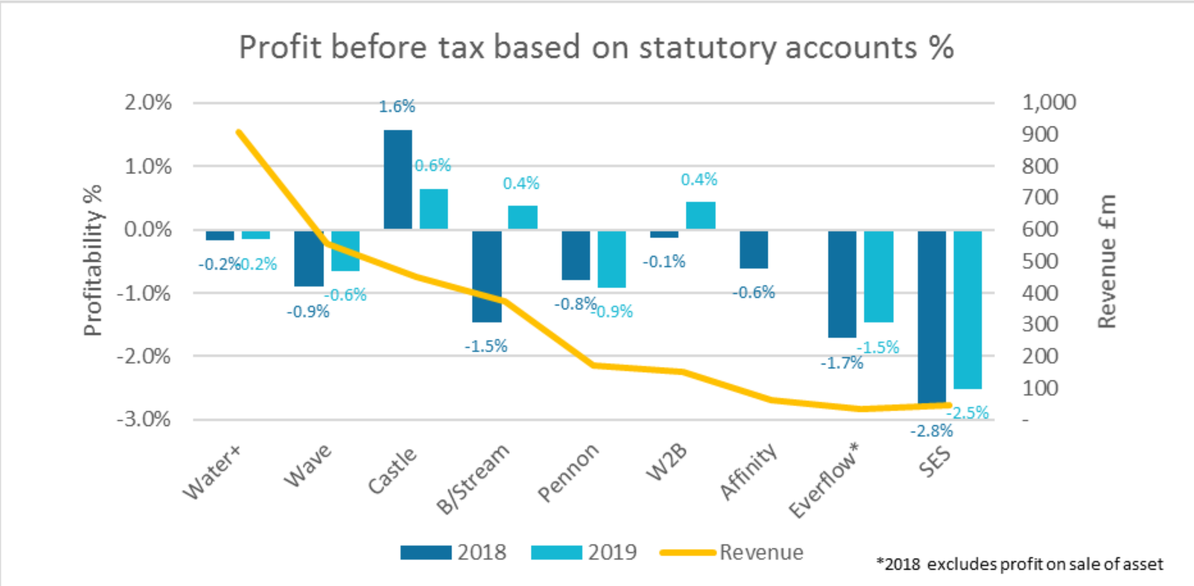
Pooling the cost proportionally across the whole market based on usage, this would negate the need for more detailed/segmented data (which Retailers may find difficult) and the associated implementation costs. It would ease the risk of error in estimating relevant excess bad debt costs for specific customer groups mitigating the potential to distort prices and competition. Pooling would also mitigate the risk of lower collection due to charges being applied only to businesses or regions with the highest financial impact.

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?*

Wave believes the fairest approach is to allow Retailers to recover excess bad debt costs where they exceed 1% more than the baseline bad debt cost level, otherwise the best performers pre-Covid are penalised.

Our preference is that the cap is 1% more than the previous level, otherwise those Retailers historically performing best are penalised. Wave has outperformed the market historically with only [redacted]% debt cost, and whilst Retailers with the average (1%) or above can expect to see 1% additional cost before they could get some protection, Wave would see an additional [redacted]% cost. On 2019/20 accounts, this additional [redacted]% would have equated to an additional £[redacted] in operating costs – in our view this is grossly unfair, as it is in effect penalising Wave for outperforming the market historically.

We do not recognise any logic in the argument of Retailers bearing a 'high proportion' in excess of 2% where excess costs are 'modest'. Our view is that the immediate positive impact on Retailer funding position already gives Retailers a clear incentive to manage bad debt costs. And the increase in debt costs (potentially [redacted]% in Wave's case) is a massive impact, when most Retailers are struggling to make a 1% profit and most loss-making based on filed accounts as shown in the table below.



A further split above 2% of ‘relatively modest’ and ‘significant’ is in our view arbitrary and introduces yet further uncertainty and complexity into the process. In our view, Retailers should be exposed to no more than 1% over normal levels.

We note that in energy, Ofgem is already proposing price increases to domestic customers to enable recovery of the costs of increased levels of bad debt by the energy companies. Although without same pricing regulation, energy suppliers have more flexibility to do this. We do believe that the principle of recovering excess market bad debt costs from customers is acceptable and also evidenced in other utility markets. See articles below.

https://www.msn.com/en-gb/money/other/households-face-extra-21-coronavirus-charge-on-energy-bills/ar-BB1bceP6?MSCC=1599829924

Extract from Utility Week, 21 January 2021 https://utilityweek.co.uk/who-can-hold-their-breath-longest/

“Customer debt is another area of huge concern. Suppliers already collectively carry £300 million of debt. Ofgem is proposing to raise the price cap by £21 to help suppliers manage increased customer debt due to the economic impact of Covid-19. This means that Ofgem anticipates Covid-19 induced bad debt of around £550 million. That debt will not fall evenly across the industry. Suppliers who find themselves particularly exposed, especially if they already have high levels of debt, may find their cashflow under huge pressure.”