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Customer Bad Debt Call for Inputs
Ofwat
Centre City Tower
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By email only to: **covidbusinessretailmarket@ofwat.gov.uk**

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Dear Sirs,

Customer Bad Debt Call for Inputs

Thank you for providing the opportunity through this CFI to share our thoughts on developing proposals for the redistribution of excess customer bad debt costs experienced by retailers in the Business Retail Market.

We have read with interest the background, objectives and proposals in your CFI document and broadly support much of the thinking and the general direction of travel.

We do see however, a number of potentially conflicting issues which have created difficulty for us in reaching a firm view on certain matters; primarily related to pooling. We are currently unable to see how the customer type pooling methodology is likely to be seen as fair by all parties, or consistent with the stated customer protection objectives of this regulatory intervention.

The considered pooling and sharing methodologies appear to be intended to collect a supplementary charge to cover excess customer bad debt from those business sectors/customers who we believe may already be;

- most impacted by the covid-19 restrictions
- likely to be responsible for much of the excess bad debt in the first place, and
- least likely to be gaining significant benefit from the existence of the market

thereby exacerbating the customer bad debt situation.

This approach seems to be irreconcilable with the first stated objective of protecting customers. Furthermore, by targeting recovery of bad debt from specific customer groups, we question whether this approach could be argued to be unfairly discriminatory.

We have responded to the majority of the questions in the attached appendix as fully as we feel able at this time, however in the absence of the information Ofwat is currently collecting via the Retailer RFI, we are not able to provide a firm view on some aspects.

We look forward to sight of appropriately anonymised information regarding the current distribution of customer bad debt by geography and customer type inter alia, in order for us to respond with greater clarity to the consultation on your final proposals.

Yours sincerely,

[redacted]

W Kimpton.
Head of Regulation
Yorkshire Water

	Question	Response
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 of the three components of bad debt costs highlighted in section 2, component 1 (debtor days and write-offs) is generally likely to be impacted most significantly by the covid-19 pandemic and related interventions and is arguably the least controllable by the management of the retailer. Component 2 (working capital) should be seen as a transient issue which initially required specific industry support, but which retailers have now had sufficient time to seek and put in place suitable measures to manage any recurrence. The final component 3 (cost of collections activity) is likely to be impacted to a lesser degree and is also within the control of the retailer. We therefore support the view that attention should be focussed on effectively and accurately measuring the bad debt impact as described.
2	- To what extent do you consider that bad debt costs may have differed by geographic region and/or by customer type?	We believe that the economic impacts of covid-19 have differed by geographical area, customer type and industry sector within which they operate. Geographically, some parts of Yorkshire have remained in Tier 3 from early July whereas other parts of the county and the country benefitted from periods of less stringent restrictions.

		Similarly, some sectors, for example hospitality and leisure have generally been subject to a greater degree of restriction compared to other sectors such as food retailing and public sector. Anecdotally, any water retailer specialising in supermarket chains and the public sector is likely to be less impacted by covid-19 generated customer debt than a water retailer specialising in caravan sites, hotels, pubs and bars. We do not have access to data which would allow us to assess the existence or scale of these effects, however we would expect the RFI returns being prepared by Retailers to evidence the degree to which such regional and sector specific impacts are observable and material.
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 measurement and reporting of bad debt costs should ideally be based on relevant accounting standards definitions. Attempts to prescribe more specific requirements could over complicate the process and give rise to a risk of inconsistency between retailers, however, the example of a pre-existing method for non-statutory accounting basis suggested in the CFI at section 2.2.1 (approach 2) appears to be relatively uncomplicated. Annual audits of statutory accounts provide an established form of control and could be used to confirm that bad debt is reported accurately and is

		consistent (subject to plausible covid-19 related adjustments) with previous years' methodologies. Note however, some small retailers may be exempt from the statutory audit requirement. We would be supportive of some form of true-up but subject to an appropriate materiality threshold.
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.	No. We believe this could lead to inconsistencies, lack of transparency and a natural bias in favour of the retailer. Please see our answer to the previous 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?	We believe (a) the proposal to allow recovery over the period of the 20/21 statutory accounts, and (b) a further six months over which to validate and quantify these unrecoverable costs to be a reasonable minimum time period. Some flexibility may be necessary as smaller retailers may have differing accounting periods to larger established businesses. Any extension to current Covid-19 restrictions should cause a review of whether this timescale should be extended.

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 believe this is matter which Retailers are best placed to comment on.
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 support the three objectives proposed for considering regulatory provisions in respect of bad debt costs, however we believe consideration should be given to making objective 1 more specific. The objective of "protecting business customers" is in the round an obvious and entirely suitable primary requirement. However, the protection could be more specific in providing financial protection for those customer groups who may be at risk of multiple impacts, by virtue of the customer potentially: • being in the customer group most impacted by the Covid-19 restrictions • being a customer of a retailer type most likely to exit the market • being in the customer group which may have seen less benefit from market opening than other customers groups (e.g. England-wide multi-site food retailers).

		• being a customer required to contribute to fund the bad debts of competitors who have failed to pay or subsequently gone out of business. Achievement of this customer protection objective could be satisfied by implementing more appropriate segmental distinctions in the mechanisms proposed in section 3.2. For example, protecting smaller customers from the debt burden of larger customers, but not necessarily vice versa. (however, we recognise it is possible any form of pooling could be considered discriminatory)
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?	The Retail Exit Code is the primary regulatory mechanism which prevents retailers recovering excess bad debt from their customers, therefore it would seem logical to consider this as the most appropriate mechanism for easing the restrictions it imposes on retailers. We believe that Retailer billing systems should be agile and flexible enough to recover additional allowed margin by incorporating an excess bad debt charge via either a fixed cost per customer uplift, an appropriate volume uplift to the retail charge, or a combination of the two. Furthermore, it would seem logical to utilise the same system for measuring and reporting bad debt, as the one used to bill and recover that same excess bad debt.

		We do however have concerns (detailed elsewhere) regarding the pooling and segmentation of customer types described which we believe does not support the prime objective of protecting customers.
9	- Do you have views about the merits of enabling the recoupment of (some portion of) excess bad debt costs through wholesale charges?	This option introduces unnecessary complexity to an already over-complex market, via wholesale charging schemes and accounting mechanisms which are not designed or intended to be used for the billing of retail costs. Such an approach could provide a rather blunt mechanism which would only deliver a blanket approach. This could impact all retailers and customers without recognition that some customers and indeed retailers may have done more to protect themselves and mitigate the financial impacts of covid-19. To then be subject to what could be characterised as a socialised ‘bad debt tax’ through an arbitrary mechanism would be unfair and potentially damaging for the reputation of the market. Similarly, this approach could also impose socialised bad debt costs on customers already close to the edge of falling into bad debt with their existing bill commitments - so intensifying debt and collections issues. Furthermore, each wholesaler has a unique structure to its range of wholesale tariffs and a variety of charging rules which we feel could create difficulty in recovering the intended value of bad debt costs into a central fund and the subsequent redistribution of those revenues with consistency across the market.

		At this stage we cannot rule out the potential for unintended consequences from utilising wholesale charges for the recovery of a retail supplemental charge. For example, impacts on PR19 allowed revenues, the reconciliation forecast incentive mechanism and totex sharing to name but three. Wholesalers are expressly forbidden from undertaking any retail activity following their exit from the business retail market via the 'exit regulations' and therefore, the collection of such revenues is not permitted within the provisions of the appointee's licence. Although such action may not necessarily be acted upon by any statutory body, the collection of a bad debt surcharge from customers on behalf of Retailers via wholesale charges, could likely be argued to be a retail activity and in effect, illegal. We would also be concerned about the potential for such action so set a precedent for future use of wholesale charges as a mechanism for financial interventions. Such mis-use of the wholesale charging mechanism has the potential for a conflict of interest, lack of transparency and subsequent misunderstanding to occur amongst customers regarding the reasoning and purpose for increased wholesale charges on the back of covid-19. This could create the potential for increased complaints and reputational damage to wholesalers.

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?	The wholesale market services function does not have the capacity to undertake and manage the significant burden and risk associated with designing, testing implementing and managing the collection of these surcharges via the wholesale charging process. Should we be required to undertake this activity we anticipate it would be necessary to make changes to CMOS, our market data interface systems, our own billing, management, accounting and assurance systems and processes. We have not yet assessed the scale and cost of the above activities or the assurance and audit needs that would be required. However, we do not see a wholesaler centric mechanism as an effective way of meeting the stated objective of promoting efficiency.
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 believe serious consideration should be given to using the Market Operator to support Retailer Trading Parties in the collection and redistribution of excess bad debt related charges through REC cap adjustments.. The Market Operator has extensive experience of developing and managing the Market Performance regime centrally for all Trading parties. A bad debt charge recovery process within the Retailer trading party community would appear to have much in common with aspects of the market performance regime:

		• Retailers report debt performance to the MO • MO compares performance between Retailers • MO determines industry and retailer levels of excess bad debt • MO determines where customer charges require to be increased • MO notifies allowable excess charges to specific retailers depending on excess bad debt performance • MO collects and redistributes collected charges to Retailers in accordance with excess bad debt performance • MO assure the process • MO responsible for governance and transparency Retailers must ultimately collect the excess charge from customers, and the Market Operator must be central to the process, but we see no obvious benefit in bringing wholesalers into the process. One benefit of undertaking this via the Market Operator is that just one central organisation is involved instead of every wholesaler. The cost of setting up one team in the MO to design, test, implement, manage assure and audit must logically be significantly less than replicating those same activities in each of the twenty wholesaler organisations.

		Given the current suspension of the MPS regime, it is possible that the MO may have skilled and experienced resources which could be readily available to develop this option at pace. This solution would appear to have a greater opportunity for efficiency, consistency and transparency than a wholesaler option.
12	- What is your view of the appropriate timing for the measurement and recovery of (a portion of) any excess bad debt costs?	We refer to our response to question 5 regarding the period to be measured and the time to measure. Regarding the timetable suggested in section 3.3, subject to the recovery mechanism being via the REC option and not the wholesale charge option, we support the proposed timetable as a basis for further detailed development which we believe is a matter Retailers are best placed to comment on.
13	- Do you agree that it makes sense to 'pool' recovery of (some portion of) excess bad debt costs across customer groups and/or regions?	We see some form of geographic or customer type pooling could be beneficial, however further information on where excess debt costs exist (via the Retailer RFI) is necessary before a firm view could be expressed. As per our response to question 7, without some form of amended customer segmentation and pooling, we see the excess bad debt charge being recovered somewhat indiscriminately from the same customer types that have been most severely impacted by the Covid-19 restrictions in the first place. The argument that pooling is necessary to protect smaller customers from subsidising larger ones is entirely supportable, but without supporting data,

		it is possible that the proposed pooling methodology will cause the additional cost burden to be borne by the customer group least able to bear it. We are also concerned that pooling by customer type could be seen to be discriminatory.
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 those customers and retailers that benefit most from the existence of the market could be responsible for a proportional share of the burden consistent with the scale of benefit they get from the market (and the customers' ability to pay by virtue of their continued trading compared to other customer groups). We do however, broadly support the sharing factors considered by Ofwat in section 3.5, however, despite recognising the benefit, we do feel that a graduated scale of parameters could prove to be complicated and costly to administer.

END