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Webinar 24th March 2021 on Consultation: Business retail market Customer bad debt

Ofwat provided a high level overview of its proposals as set out in its March 2021 consultation on customer bad debt. It confirmed these are aimed at protecting the interests of business customers in the short and longer term, including from the risk of systemic retailer failure. In doing so Ofwat is seeking to: minimise additional costs for customers in the shorter term by promoting efficiency and supporting competition; and provide additional clarity to retailers and their investors.

Questions and Answers

1. **The UKWRC[1] had developed a scenario in which the proportions of excess bad debt absorbed by retailers was ≈80% and non-household customers was ≈20%. This assumed outturn bad debt was 2.9% and defined excess bad debt as any bad debt in excess of 1%. The UKWRC questioned whether this was consistent with Ofwat's proposals.**

   Ofwat confirmed UKWRC's calculations looked right but emphasised Ofwat is defining 'excess' bad debt as any market-wide bad debt over and above 2%. In April 2020 - and on the basis of historical data - Ofwat had confirmed that a prudent and efficient retailer should be expected to bear bad debt costs of up to 2% in full.

2. **The UKWRC had developed some scenarios to illustrate that additional regulatory protections would depend on the profile of bad debt over time – if the additional bad debt arising from Covid-19 is spread across a number of years, this could prevent the 2% threshold being met.**

   Ofwat confirmed its decision that retailers should be expected to bear bad debt costs of up to 2% (of total annual non-household revenue) in full. This is also expected to be the case if bad debt costs exceed 2% each year in 2020/21 and 2021/22. Retailers requested that Ofwat consider the option of a blended average over time. Ofwat requested that Retailers set out their views and supporting evidence in their consultation responses.

[1] Questions 1-3 relate to some questions that the UKWRC had shared with Ofwat prior to the webinar.

3. **How would the any upward adjustments to the price caps proposed dovetail into the wider review of the REC price caps to be implemented from April 2023?**

   Ofwat confirmed it would be consulting on any changes to REC price caps during 2022, with any adjustments to be implemented from April 2023. These adjustments will be forward looking, based on efficient costs, but may also need to reflect backward looking excess (Covid-19 related) bad debt costs. This could potentially result in Ofwat setting a path for prices from April 2023, with the potential for downward adjustments once excess bad debt costs had been allowed for.

4. **Has Ofwat recognised that 2% of total revenue as a threshold for bad debt costs represents a large proportion of the operating costs and revenue in respect of retail operations, given that the majority of total revenue received by a retailer will be passed through to wholesalers as wholesale charges?**

   Ofwat confirmed that it recognises this position.

5. **Will the true up apply on an annual basis? And if the true-up indicates that outturn market-wide bad debts are less than 2%, would the regulatory protections be clawed back?**

   Ofwat said it hadn't yet developed a detailed proposal on how the true up would work – the final true up might be included as part of the wider REC review. Ofwat confirmed that if excess bad debt levels were calculated on the basis of an individual year (and not averaged across years) then this is also how it expected the true up to work. Ofwat also confirmed that if outturn market-wide bad debts turn out to be less than 2%, then additional regulatory protections would be 'clawed back' to protect customers.

6. **How does Ofwat envisage an uplift to the REC price caps working for contracted customers?**

   Ofwat confirmed that the REC price caps do not apply to customers who have engaged in the market and negotiated a new contract with their retailer or switched to a new retailer. To the extent competition allows, retailers already have the ability to increase prices for these customers. An uplift to the REC price caps should allow retailers to increase prices for contracted customers and still remain competitive to the (uplifted) price caps. Recognising that such a response may take some time, Ofwat has proposed that any uplifts to the REC price caps take place over a minimum of two years. Ofwat also confirmed that recovering excess bad debt costs from customers via the REC price caps would not involve any use of a central fund. A central fund would only be relevant for consideration where recovery was via wholesale charges or a retail levy.

7. Will any uplift to the REC price caps be based on some sort of weighted average?

Ofwat confirmed any uplifts to the REC price caps were likely to be based on some form of weighted average but it had not developed detailed proposals on this yet.

8. Will any bad debt costs arising from self-suppliers be included in estimates of excess bad debt costs or uplifts to the REC price caps?

Ofwat said it did not expect bad debt costs arising from self-supply customers to be reflected in these estimates.

9. What is the rationale for the proposed two-step sharing factor?

Ofwat explained that if excess bad debt costs turn out to be only marginally above 2%, then there may be a case for retailers to bear a larger proportion of these and customers a smaller proportion. But if outturn bad debt costs start to increase materially beyond what a prudent retailer could expect or have planned for, then there may be a stronger case for retailers to pass through a greater proportion of these excess bad debt costs to customers.

Ofwat explained it is consulting on these parameters and seeks views and evidence. It recognises that a two-step approach does create a further cliff edge. However Ofwat was clear that any sharing factors need to maintain strong incentives on retailers to recover bad debt, which would not be the case if the proportion of costs borne by retailers were less than their expected debt recovery costs. Ofwat is encouraging retailers to share data and evidence on their debt recovery costs in response to the consultation.

10. In its consultation Ofwat proposes to allow some relief for efficiently-incurred financing costs. What is required from retailers as supporting evidence on this?

Ofwat confirmed it had not yet developed a proposal about how efficiently incurred working capital costs should be estimated. It welcomes stakeholder views and supporting evidence on this in consultation responses.

11. **Will Ofwat consider calculating uplifts to the REC on a company by company basis? A uniform, market-wide uplift to the REC price controls will reflect excess bad debt costs across the market, with each individual retailer having little control over this. In addition, different accounting policies between retailers could affect whether 2% threshold is breached and how in a given year.**

    Ofwat confirmed its proposal was to calculate a uniform, market-wide uplift to the REC price caps, based on levels of excess bad costs across the market. This approach is intended to reflect what would happen in an unregulated / competitive market where competition maintains incentives on individual companies to manage costs and where companies will face some uncertainty about future revenue streams. Ofwat requested that Retailers set out their views and supporting evidence in their consultation responses.

12. **If the national average is 3% and an individual company's debt is 4% for FY21, then under Ofwat's proposals would the REC cap increase by 0.5%?**

    Ofwat confirmed this was correct. Similar to an unregulated / competitive market there are likely to be winners and losers, depending on how efficient individual retailers are at managing bad debt levels. This should maintain incentives to keep bad debt costs low and minimise additional costs to customers.

Next steps

Ofwat confirmed the **deadline for consultation responses is 5pm Tuesday 6th April 2021**. It expects to issue a further retailer request for information (RFI) mid-April for response by end May. Ofwat confirmed its present intention for this to be broadly similar to previous RFIs but noted it may for example include a more detailed breakdown on some customer groupings as well as data relating to working capital costs.