Ofwat Consultation on Customer Bad Debt Costs

Business Stream Response

Thank you for the opportunity to respond to Ofwat's consultation on customer bad debt. In the paper attached we have provided responses to each of the questions posed in the consultation.

We welcome Ofwat's commitment to providing a cost recovery mechanism, but we don't believe that the proposal goes far enough to protect customers from the risk of systemic retailer failure.

We believed that Ofwat had understood the difficult financial position in which most retailers now find themselves as a result of COVID, and the need to provide the market with clarity and regulatory certainty about the scope for recovering the excess bad debt costs resulting from COVID. Instead, the proposal outlined in the consultation paper provides only limited support to the NHH market, it creates disparity between retailers, and perpetuates uncertainty over if, when and to what extent a retailer will be able to recover its bad debt costs.

We are particularly disappointed given that retailers have for the most part provided extensive support to their customers over the last year, ceasing debt recovery activities, providing payment deferral and extended recovery plans to those businesses worse affected, whilst continuing to pay wholesale charges in full, despite customer non-payment. The treatment of retailers appears to be in stark contrast to the treatment of wholesalers, who have been allowed to increase their charges from 1st April 2021 in order to recover lost revenue experienced in 2020/21 and expected in 2021/22 as a result of COVID, with no suggestion of any sharing mechanism or delayed recovery to minimise the impact on customers. Meanwhile, retailers were given an expectation that we'd have to bear the cost of an additional 1% of bad debt, but we are now being asked to fund 1% plus 25%-50% of any increase above that, and we are not being allowed to recover our actual bad debt costs because the recovery is based on a market average.

We have provided more detail in the paper attached, but have summarised below our key concerns together with four amendments to the proposed scheme that we consider would make it fairer and more consistent with the stated objectives.

1. **Multi-year effect** (see also response to Q3):

   Initially Ofwat set an expectation that retailers would have to absorb an additional 1% above their normal bad debt levels, but that excess bad debt beyond that would be recoverable through a support mechanism. Now we understand that if the scheme extends to more than one year (which seems inevitable), Ofwat expects retailers to absorb an additional 1% each year.

   An additional 1% bad debt is ~£25m. To set that in context, the total profit (PBT) earned across the whole retail market in 2018/19 was less than £5m. No retailers have posted a profit since then[1].

   Instead of retailers being expected to meet an additional 1% of bad debt each year that the scheme is required, we propose that this is applied only once, for 2020/21 bad debt, and that for each year thereafter excess bad debt is defined as everything above the 1% norm.

[1] Based on accounts of the 8 largest English retailers published by Companies House as at 1st April 2021. In 2018/19, only 3 of these retailers made a profit, this includes profit from their Scottish business where they had one. The losses of the other retailers totalled £7.9m, so the net position of the market as a whole was negative.

2. **Sharing parameters** (see also response to Q8):

   Ofwat's sharing mechanism proposes that in order to provide an incentive to continue attempting to recover debt, retailers would have to bear an additional 25%-50% of excess bad debt costs, in addition to the extra 1% they are already being asked to fund.

   We believe that an accurate incentive should be linked to the cost of debt recovery. In the body of our response we have included evidence to demonstrate that 10% would be a sufficient incentive to ensure that retailers continue to manage their debt effectively.

3. **Recovery mechanism** (see also response to Qs 6&7):

   The use of an average REC uplift as the recovery mechanism for excess bad debt costs creates a number of distortions:

   - *disparity between retailers*: it creates winners and losers, preventing retailers with higher than average bad debt cost (as a result of their customer mix, the extent to which they supported customers during COVID, regional lockdown restrictions etc) from recovering their full costs; but providing retailers with lower than average cost with a windfall;
   - *inequity between deemed and contracted customers*: such that contracted customers, often the largest and financially strongest customers, may be able to avoid making a contribution to COVID bad debt cost; and
   - *unmanageable risk*: the timing and extent to which a retailer is able recover its bad debt costs is dependent on the debt levels of all other retailers and their accounting judgements over which it has no control and which cannot be predicted.

   The recovery of bad debt through a wholesale uplift is the only mechanism that would avoid all three of these distortions. However, we recognise that it is a more complex option than the REC, hence we have two alternatives for amending Ofwat's REC proposal that would go some way to addressing these issues:

   (i) *Uniform REC recovery and redistribution*: As proposed, retailers recover a uniform uplift from deemed customers and contracted customers where possible, but funds are then pooled and redistributed to retailers on the basis of demonstrated cost incurred; or

   (ii) *Company specific REC recovery*: the REC is amended to allow each retailer to recover their own (validated) bad debt costs, and retailers have the competitive freedom to recover what they consider reasonable up to that level. We believe that this is more akin to the effect of a competitive market than the current proposal. Retailers could choose when to commence recovery (Q5) and over what period (Q13).

4. **Exclusion of debt incurred prior to January 2020** (see also response to Q4)**;**

   We agree with Ofwat that the most efficient and simplest means of estimating and truing-up bad debt is the use of retailers' accounting provisions. However, the use of a cut-off date to exclude pre-COVID debt would be inconsistent with this, because provisions are made on the basis of the likely recoverability of outstanding debt at any point in time. Retailers will have debt from before January 2020 that has become unrecoverable as a result of COVID (and Ofwat's prohibition on debt recovery activities).

   The key to precluding normal or pre-COVID debt from the recovery mechanism would be a robust distinction between BAU and COVID-19 provisioning, not a cut-off date from which debt became COVID debt. It is important to recognise that some retailers will have made provision for COVID bad debt in their 2019/20 accounts as well as 2020/21.

We recognise that these are unprecedented times and that we are dealing with exceptional challenges. We are keen to remain involved and we’d be happy to discuss any part of our response in more detail.

Customer Bad Debt Costs

Consultation Question 1. Our analysis on the basis of data available to date suggests that market-wide customer bad debt costs have, or are likely to, exceed 2% of total NHH revenue. What is your view concerning likely outturn bad debt costs for the year 2020/21 and into 2021/22?

We continue to believe that customer bad debt costs for the year 2020/21 are likely to exceed 2% of annual revenues. [redacted] it is too early to say how much of the debt that has accumulated during 2020/21 we will be able to collect from customers.

We also continue to be of the view that the full impact on businesses of COVID-19 will only be felt once the furlough scheme and other Government support comes to an end. Given that the support schemes have now been extended into 2021/22, we believe it will have the effect of spreading the impact over a longer period than might otherwise have been the case. We are concerned that we could see a second wave of bad debt building during the second half of 2021/22 placing sustained pressure on retailers' already weakened cashflows.

Consultation Question 2. To what extent do you consider that lower consumption customers have been affected more significantly by Covid-19 measures resulting in a potentially larger rise in bad debt costs, relative to larger consumption customers?

As we demonstrated in our CFI and RFI responses in January, the increase in aged debt during 2020/21 has been most marked amongst our SME customers, indicating that they have been most affected by the pandemic, although there will inevitably be larger customers in the hospitality and retail sectors for example who have also been badly affected.

However, Ofwat's proposal for a two-pool recovery mechanism (Q11) raises an interesting question of principle: whether surviving SME customers should bear the bad debt cost associated with other, potentially failed, small businesses (because they represent a higher payment risk) or whether it is the opposite, i.e. that these customers are least able to afford it, and hence we should look to larger customers who have been less affected to also bear a proportion of the cost. At this stage it seems likely that the wider costs of COVID on the country will be recovered proportionately across all sectors of the economy (e.g. through taxes), rather than targeting those sectors who have been in receipt of furlough support for example and asking them to repay it. Targeting cost recovery at the most vulnerable groups may simply increase the risk of bad debt amongst that group.

Timing Issues

Consultation Question 3. Do you agree that it is likely that the impacts of the pandemic, and possibly increases in bad debt costs will continue to accrue during 2021/22 and possibly beyond?

Yes, we agree that the impacts of the pandemic and the risk of excess bad debt will continue to accrue into 2021/22 and beyond. As indicated in response to Q1 above, we believe that many customers have been protected by Government support, but once this support is withdrawn, it may lead to a second wave of customer non-payment as businesses try to get back on their feet in a challenging macro-economic environment.

However, this raises a point of major concern. Initially Ofwat set an expectation that retailers would have to absorb an additional 1% above their normal bad debt levels, but that excess bad debt beyond that would be recoverable through a support mechanism. Now we understand that if the scheme extends to more than one year, which seems inevitable, Ofwat expects retailers to absorb an additional 1% each year.

As the example below shows, if bad debt had all accrued in 2020/21, the retailer in this instance would have been able to recover (a share of) 4%, but if the same impact is spread over 2 years, under Ofwat's proposal the retailer would only be able to recover (a share of) 2%., and if over three years, nothing. Given that the collective impact on the retailer is the same under all three scenarios, it would be wholly arbitrary to provide for different levels of recovery under different circumstances.

	Year 1	Year 2	Year 3	Recoverable
BD - scenario 1	6%	1%	1%	4%
BD - scenario 2	3%	3%	1%	2%
BD – scenario 3	2%	2%	2%	0

Even before COVID, few retailers were able to make a profit in this market and the position has deteriorated during 2020/21. To give some context, an additional 1% bad debt is ~£25m. The total profit (PBT) made in the whole retail market in 2018/19 was less than £5m. No retailers have posted a profit since then[2].

We don't believe that it is viable for retailers to continue to absorb an extra 1% of bad debt for a further year or more. Negative returns and onerous working capital requirements risk driving retailers from the market.

Instead of the retailers being expected to absorb the additional 1% each year the scheme is required, we propose that this is applied only once, for 2020/21 bad debt, and that for each year thereafter excess bad debt is defined as everything above the 1% norm.

Alternatively, if debt levels continue above 2% for more than a year, it would cease to be 'exceptional' but effectively becomes a new 'norm', which could be reflected in an enduring uplift to the price control allowance.

Consultation Question 4. Do you agree that, since bad debt costs may take time to manifest, there is merit in using available Retailer accounting data to estimate an initial revision to regulatory protections, followed at a later stage by a 'true up'?

Yes we agree that retailers' bad debt provisions should be used as the basis for estimating (a) whether the 2% threshold has been reached; and (b) each retailer's bad debt costs; and that these estimates would be trued-up as audited data becomes available over time. It is the simplest, most transparent and most cost-effective approach. However, we foresee two significant issues with the way in which Ofwat has proposed that these estimates are used.

(i) The exclusion of bad debt arising prior to January 2020

Ofwat has proposed both the use of companies' accounting provisions and the use of a cut-off date to define COVID bad debt. However, the two are inconsistent. If we use statutory accounts as the basis for defining retailers' bad debt, bad debt provisioning will include the company's view on how much of the debt outstanding at any one time will be recoverable. As we explained in the CFI

[2] Based on accounts of the 8 largest English retailers published by Companies House as at 1st April 2021. In 2018/19 only 3 of these retailers made a profit, including from their Scottish businesses where they had one. The losses of the other retailers totalled £7.9m.

response, retailers will have debt from before January 2020 which has become unrecoverable as a result of COVID restrictions (and the Ofwat prohibition on debt recovery activities) – this will be reflected in their bad debt provisioning. The key to precluding normal or pre-COVID debt from the recovery mechanism would be a robust distinction between BAU and COVID-19 provisioning, and not a cut-off date from which 'normal' debt became 'COVID-19' debt. It is important to recognise that some retailers will have made COVID bad debt provisions in their 2019/20 accounts as well as 2020/21.

(ii) The use of an average uplift to the REC

The use of company accounting data works where each retailer is trued-up against their own accounting policy, e.g. if retailers over or under-provision, this will be trued up through their accounts with subsequent adjustments and write-offs. However, under Ofwat's proposal to make a uniform uplift to the REC based on an average market-wide bad debt cost, legitimate differences in accounting policy between companies has the potential to create distortions. It means that the timing and the extent to which a retailer would be able to recover their excess bad debt would be affected by the accounting policies (BD provisioning) of other retailers over which they have no control. This would not be reasonable.

As a simplified example, the market contains only 2 retailers, with 50/50 market share, both of whom incur 5% bad debt. Retailer A could choose (legitimately) to make no BD provision and only recognise bad debt as write-off when all recovery options have been exhausted. On the other hand, Retailer B may decide (also legitimately) to make a 5% provision up front. This would result in the 'market average' BD being estimated initially at 2.5%, leading to significant under-recovery for Retailer B, and initial apparent over-recovery for Retailer A. As each retailer is blind to the accounting policies of the other, they have no way of knowing how the average will be trued-up over time and hence what proportion of their own bad debt they will be able to recover or when. This creates a massive uncertainty for retailers, especially given the magnitude of the amounts at stake, which will undoubtedly affect retailers' ability to finance their business. Why would lenders or shareholders provide funding if they are unable to see whether and when it will be repaid.

To be clear, we support the use of accounting data, but not the use of an average REC uplift. We expand on our concerns about the REC approach in response to Q6&7 below.

Consultation Question 5. Where we revise any regulatory protections, we are minded to implement them such that they take effect from April 2022. We note that an alternative, basing any revisions on the basis of currently available data, could take effect from October 2021. Do you agree with our minded to position? Please explain your answer.

It is disappointing that an adjustment could not have been made for the recovery of excess bad debt from April 2021, in the same way as in the energy sector, and indeed in the same timescales as the wholesalers are recovering their 2020/21 COVID costs.

We are also disappointed that Ofwat has dismissed our suggestion that if the BD recovery mechanism doesn't take effect until 2022, that wholesalers provide some support to retailers in the meantime. Wholesalers will be fully recompensed for the impact of COVID from April 2021, and given that more than 90% of the bad debt relates to wholesale charges, it seems extraordinary that they bear no responsibility for supporting NHH customers affected by COVID.

If the support mechanism does not commence until 2022, we are pleased to see that Ofwat has agreed to include the cost of financing the bad debt in the recovery mechanism.

As we indicated in the CFI response, we have concerns about the impact on customers of an unexpected mid-year price change, [redacted]. However, there will be other retailers for whom a mid-year price change would be less of an issue, and it would be disingenuous to propose waiting, if there is an option to implement the recovery mechanism from October 2021. We would however, ask that if the recovery mechanism is introduced from October, retailers should have the option of delaying implementation until April 2022, for some or all of its customers, without suffering any financial detriment i.e. funds that could have been recovered between October and March can be recovered from April 2022.

COVID Bad Debt Recovery Mechanism

Consultation Question 6: Do you agree with our presented 'minded to' view that amendment of REC price caps is the approach that best meets our objectives concerning customer bad costs?

Consultation Question 7: Do you agree with our assessment of the options for revision of regulatory protections?

No we do not agree with Ofwat's assessment of the options presented, nor do we agree that an uplift to the REC based on average bad debt costs will be in the best interests of customers or the resilience of the NHH market. Whilst it might be the simplest to implement, an average REC uplift, as proposed, has the potential to seriously distort competition and make it impossible (or very expensive) for retailers to raise finance to support the debt.

The two key issues of most concern are:

(i) *inequity:* it discriminates between deemed and contracted customers, and skews the competitive playing field, penalising some retailers and rewarding others without justification; and

(ii) *uncertainty:* the proportion of bad debt costs that a retailer is able to recover is dependent on the accounting policies and bad debt levels of other retailers over which it has no control, and which may not be known for a number of years.

Inequity

Ofwat highlighted in the Consultation paper, that the RFI returns provided by retailers showed a wide range of estimates of bad debt, from zero[3], to in excess of 10% (which in itself makes the proposal of an average uplift an odd choice). Whilst this may, as Ofwat implied, be a reflection of retailers' debt management efficiency, other potentially more significant drivers of variations in bad debt projections include:

(a) differences in accounting policy: the extent to which retailers provide for anticipated bad debt in advance or wait and only write off debt when they have exhausted all recovery options;

(b) customer base: a retailer with a handful of large customers or whose customers have been selectively targeted, credit vetted and who pay in advance, is likely to have a much lower incidence of bad debt than a retailer with an inherited customer base, which includes a significant proportion of SME customers most affected by COVID restrictions, and whose payment and collection terms are constrained by the REC; and

(c) level of support provided to customers during COVID: retailers who provided greatest support to customers affected by the pandemic – ceasing debt recovery and offering payment deferral – are likely to have a higher propensity for bad debt than retailers who were less supportive.

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[3] We assume that this does not include data from self-suppliers, who by definition will have zero bad debt, and whose inclusion would artificially lower the market average.

These are not reasons to reward or penalise retailers – allowing some to significantly over-recover and others to recover only a fraction of the bad debt actually incurred. A REC uplift based on a market-average will not mitigate the risk of retailer failure, given that those with highest bad debt provisioning will receive least support; instead it artificially skews the competitive playing field in favour of those retailers with low bad debt provisioning.

In a small, non-household market, where customer portfolios can be diverse, there will inevitably be a legitimate range of propensity for bad debt amongst retailers. We suggest below how the REC uplift mechanism could be amended so that it is tailored to retailers' actual circumstances – thus reducing risk and providing greater certainty.

The use of the REC as the support mechanism also means that the uplift will apply only to those customers on tariffs regulated by the REC (rather than a wholesale uplift or a retail levy, which can be applied to all customers equitably). The extent to which retailers will be able to pass through an uplift to customers on contract will depend on their individual terms and conditions, but these customers may be able to avoid making any contribution to COVID bad debt costs – which feels discriminatory. In these cases, retailers with a large proportion of contracted customers, subject to individual terms and conditions, would be disadvantaged compared to those with a greater proportion of deemed customers.

Uncertainty

We have illustrated in response to Q4 above how legitimate differences in retailers' provisioning policies could increase or reduce the calculation of the market average, such that the extent and timing of any retailer's bad debt cost recovery under the Ofwat proposal would be dependent on the accounting policies and decisions of other retailers. Under an average uniform REC uplift, a further layer of unmanageable risk and uncertainty is caused by the dependency of each retailer on the actual bad debt incurred by all other retailers, including those with radically different customer portfolios and approaches to debt management. This makes it impossible to predict if, when, and to what extent bad debt costs can be recovered. Such uncertainty will make financing of this debt incredibly difficult (and incredibly expensive).

Ofwat indicates that a uniform REC uplift provides retailers with "*competitive freedoms*", suggesting that retailers whose estimates of bad debt costs are lower than average would be able to choose not to pass the full uplift to customers. However, we don't believe that this will be the case as retailers will not be able to take the risk that:

(a) their own outturn bad debt is worse than their provision; and/or

(b) the market average turns out to be lower than the initial estimate and retailers are required to effectively re-pay customers the over-recovery.

Consequently, customers will be no better off as a result of using an average uplift (the total amount recovered will still be the aggregate bad debt cost of all retailers), compared to one which allows each retailer to recover their own costs. However, customers could be worse off if it means some retailers significantly under-recover and the risk of retailer failure is not addressed.

Alternative Proposals: Amendment to the REC Uplift Mechanism

The benefit of the wholesale charge uplift option is that it applies to all customers equitably, and allows all retailers to recover the bad debt costs actually incurred. It gives greater certainty to the market and avoids arbitrarily advantaging some retailers over others. We recognise that wholesalers are opposed to an uplift in wholesale charges and that the REC is a more attractive option to Ofwat because it would be simpler to implement. Consequently, we have suggested below, two options for amending the REC, which go some way to addressing the issues caused by the use of the market average, rather than company specific, bad debt costs.

(a) **Uniform REC recovery and redistribution**: As proposed by Ofwat, retailers recover a uniform uplift from deemed customers, and contracted customers where possible, but funds are then pooled and redistributed to retailers on the basis of demonstrated cost incurred.

Whilst this requires an extra step in the mechanism, in practice, it will require no more data to validate each retailer's individual position than Ofwat's existing proposal in relation to the calculation, validation and true-up of the aggregate market-wide bad debt cost. Hence the only additional activity would be the administration of the redistribution of funds.

or

(b) **Company specific REC recovery**: the REC is amended to allow each retailer to recover their own (validated) bad debt costs, and retailers have the competitive freedom to recover from their customers what they consider reasonable up to that level.

We believe that this is more aligned to the effect of a competitive market than the current proposal. Retailers could also choose when to commence recovery (Q5) and over what period (Q13), which would also increase the likelihood of being able to recover a contribution from contracted customers.

Sharing Factor

Consultation Question 8. If market-wide bad debt costs are 3% or lower, we propose Retailers and NHH customers should each be expected to bear 50% of excess bad debt costs. If market-wide bad debt costs exceed 3%, we propose Retailers should be expected to bear 25% of excess bad debt costs and NHH customers 75%. Do you agree this proposal meets our stated policy objectives? Please explain your position and provide supporting evidence (including evidence on costs of recovering bad debt from customers).

We understand the principle of Ofwat's proposal that retailers bear a proportion of the excess bad debt in order to provide an incentive to continue trying to recover debt from customers. However, it is not realistic to expect retailers to bear a further 25%-50% of the excess bad debt when we are already being asked to fund an additional 1%. To reiterate the context provided in response to Q3, an additional 1% bad debt is ~£25m. This is five times the total profit[4] (PBT) made in the retail market in 2018/19 – which is the last time any retailer posted a profit.[5].

We argued in the CFI response that the proportion of excess bad debt that retailers bear should be linked to the cost of debt recovery – the activity that it is seeking to incentivise. Hence we are very pleased to see that Ofwat has recognised this point. It is not clear however, how either the proposed 50/50 or 25/75 split is based on the cost of debt recovery. In response for the request for evidence of debt recovery costs:

[4] In some cases this will also include profits from retailers Scottish business where they have one.

[5] Based on accounts of the 8 largest English retailers published by Companies House as at 1st April 2021.

- Business Stream's total cost of debt recovery in 2019/20 (the last year unaffected by COVID) [redacted]

- However, as we suggested in the CFI response, we could assume that COVID debt will be more difficult to recover and will require greater input from third party debt collection agencies (DCAs) and lawyers, who will be more expensive than our in-house team. In 2019, our DCA and legal costs [redacted].

Consequently, if retailers were only able to recover 90% of the excess bad debt, it would provide sufficient incentive to try and recover the additional 10% from customers (if even using the most expensive resources, the highest estimate of the cost of doing so [redacted]

Ofwat has indicated that the sharing proposal seeks to balance the risk of systemic retailer failure with minimising additional costs to customers and used illustrative examples to demonstrate the impact on customers and retailers. Whilst we recognise that they are illustrative only, these worked examples omit two very significant factors, which means they don't capture the real risk of systemic retailer failure:

(i) retailers are not making 2% net margin, so the impact of any form of sharing will mean that retailers make bigger losses, not smaller profits; and

(ii) Ofwat's examples attempt to show the impact on the average retailer. By definition, a number of the retailers in the market will have higher than average bad debt, so they will be unable to recover a much greater proportion of bad debt than illustrated, and the financial impact will be considerably worse than Ofwat's assessment.

We are concerned that the combination of the 2% threshold, the proposal to exclude debt pre-dating January 2020, the use of an average uplift, delayed recovery and this sharing mechanism will mean that the COVID bad debt support mechanism in fact provides very little support to those with highest levels of bad debt, and so does not mitigate the risk of retailer failure.

Within this context, and based on the evidence of our bad debt recovery costs included above, we reiterate that a 90/10 sharing mechanism would provide adequate incentive for efficient debt management, without simply burdening retailers with further cost. A flat rate would also provide retailers and customers with greater certainty than a sliding scale.

Application of the REC uplift

Consultation Question 9. Do you have views concerning the approach to setting the revision of the REC price caps with respect to excess bad debt costs?

For the reasons stated in response to Qs 6&7 above, we don't believe that an average REC uplift is an equitable approach to providing bad debt support to retailers. We have nevertheless suggested that if the REC is considered to be the simplest mechanism for the recovery of bad debt costs, Ofwat's proposal could be amended to ensure that retailers recover costs actually incurred, rather than over or under-recovering. A number of the steps outlined at (i) to (vi) on pages 42/43 of the consultation would remain relevant under the amended approaches that we've suggested, but the final data requirements would need to be assessed once the mechanism is finalised.

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[6] Excluding the Yorkshire acquisition costs or revenues made in Oct 2019.

Consultation Question 10. How in your view should efficient finance costs of bad debt be defined and estimated where we make an allowance for efficient working capital costs?

We welcome Ofwat's proposal to include financing costs as well as the bad debt cost itself in the support mechanism. However, we are concerned that in a competitive market, where everyone is different, a uniform 'efficient' allowance for financing cost would create disparity within the market in the same way as a uniform price uplift for bad debt.

We foresee two key considerations:

(i) the actual costs of financing will be dependent on each retailer's financial structure, ownership, credit rating, historic financial performance etc. as well as the time at which it was secured; and

(ii) retailers must be treated consistently and the recoupment of the working capital costs associated with COVID bad debt must not leave retailers better or worse off than they would have been pre-COVID, i.e. it should not reward under-performing retailers who would have required financing regardless of COVID, nor penalise the more financially resilient retailers who have been able to fund some or all of their working capital from their cash reserves.

We suggest that each retailer should be able to evidence the actual cost of finance secured between April 2020 and March 2021 (and should include the cost of wholesale charge deferral used by some retailers in the summer). The weighted cost of this finance would then be applied to the value of that retailer's COVID bad debt. This way retailers who have funded working capital from cash reserves are not penalised for having used them, but it does not over-compensate those who have needed to raise working capital over and above for COVID bad debt. Where retailers have not had to raise finance to fund their COVID bad debt, or have relied entirely on shareholder injections, an industry-wide weighted average could be applied to their bad debt value.

Consultation Question 11. Do you agree that there is merit in enabling recoupment of (a portion of) excess bad debt costs in two 'pools'; one relating to customers with annual consumption below 0.5Ml, and another for customers with annual consumption 0.5Ml to 50Ml? Or should we pool bad debt arising from both groups of customers and calculate an average uplift to the price caps across this combined group? Please explain your answer.

As we indicated in response to Q2 above, there is no doubt that, in general, our small to medium sized customers have been more badly affected than our larger customers (although there are exceptions) but those most affected are not confined to the 0-0.5Ml consumption category and a significant proportion of our doubtful debt sits at the lower end of the 0.5-50Ml consumption band.

In principle, we question whether those customers who have been worse hit should face a higher proportion of the cost of COVID than those who have been least impacted, which is our understanding of how Ofwat's two-pool approach would work. We would rather the cost of COVID is recovered more fairly across all sectors of the business community.

We would be especially opposed to the two-pool approach if the 2% threshold was applied separately to each pool. From Fig 6 in Ofwat's paper, it looks as though the provisioning for the 0.5-50Ml customer group is close to 2%. If the 'market average' bad debt from this group was considered to be below 2%, it could result in the larger and more financially resilient customers making no contribution to the cost of COVID, and the burden would fall disproportionately on smaller customers and retailers. It would not be transparent for customers and creates further uncertainty for customers and retailers.

Consultation Question 12. Do you have views concerning the data and information Ofwat intends to seek with a view to enabling the setting of adjustments to the REC price caps?

It is in everyone's interest that the bad debt recovery mechanism is based on accurate information, which is applied in a transparent and fair way.

The data and information required to administer the scheme will depend on the form of the recovery mechanism – which is yet to be finalised – but of the data listed in table 4 of the Consultation, our initial observations are that:

- there may be constraints around the level of data available in relation to unique customers rather than SPIDs/premises. It is not clear why customer data is required when the REC is based on numbers of premises; and
- as explained in response to Q4 above, bad debt provisioning is not done on the basis of when services were consumed, but rather on the age of the debt. The data that Ofwat needs is therefore the difference in provisioning between BAU and COVID.

Consultation Question 13.

(a) What are your views about the time horizon over which any amendment to the REC price caps made in respect of excess customer bad debt costs should apply?

(b) Do you agree that there is merit, in adjusting REC price caps, both to committing to such adjustments enduring for at least two years, and that such increases should be attenuated to minimise potential price rises for customers?

In response to part (a), there remain considerable uncertainties regarding the time period over which excess bad debt will continue to accrue, but we anticipate that the most severe impacts will be felt in 2020/21 and 2021/22. If the recovery of these costs does not commence until 2022, then we would see the scheme operating over the following two years – i.e. the period of recovery reflects the period over which debt accrued. Hence if excess bad cost (or true-up) continued to accrue for a third year, we would anticipate the recovery period to be extended accordingly.

In part (b), Ofwat seems to be suggesting that the period over which retailers' costs are recovered could be extended beyond the period over which bad debt accrues in order to minimise the impact on customers. Whilst we want to do the right thing by our customers, and to provide support where we are able, this approach would be inconsistent with the approach taken by wholesalers in relation to recovery of wholesalers' COVID costs, which have already been passed through to customers, with no expectation that costs be 'shared' or that wholesalers would delay recovery in order to minimise the impact on customers.