Customer Bad Debt March 2021 Consultation

Response of Castle Water Limited

Introduction and summary

This is the response of Castle Water Limited ("**Castle**", "**we**") to the Ofwat consultation (the "Consultation") issued on 5 March 2021. To the extent that the Consultation reflects the views we expressed in our response to Ofwat's November 2020 Call for Inputs ("**the November CFI**"), please read this response in conjunction with our previous submission, as referenced below.

In summary:

- The incidence of bad debt arising from Covid-19 is likely to increase in the next two years and probably to persist past the next REC review point.

- We consider the use of an uplift to the REC to meet the need for simplicity of design and execution. However:

  - Applying the 2% threshold in each year places too much reliance on the exact application of accounting standards and policies that are by their nature flexible. The recovery mechanism should reflect the economic and commercial impact. The only way to do this is to focus the initial estimation and any subsequent true-up on the cumulative impact as represented by actual bad debt write offs. It is especially important to understand the difference in timing for writing off debts owed by limited companies compared with unincorporated customers - e.g. sole traders or partnerships.

  - The proposed sharing factor does not properly recognise the impact on retailers and their customers. Retailers not only stand to lose 100% of the first 1% of bad debt above normal levels but have also had to incur higher costs and lower revenues, with many customers' accounts at negative margins. We propose that the sharing factor should be constant at 75% customer weighting, which would not blunt the incentive to manage bad debt.

We comment below in further detail on these and other elements of the Consultation.

<u>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?</u>

As set out in our response to Question1 of the November CFI, there are lags of up to several years in establishing true levels of bad debt. We are seeing only emerging evidence of the business closure and insolvency that will arise from the restrictions imposed by the Government since the start of the pandemic. We have still to emerge from the latest lockdown, with significant uncertainty over whether restrictions may continue in the remainder of 2021 and possibly beyond. And we do not know how much the impact has been merely delayed by the business support measures taken. There are multiple reasons for the time lag, including: the time currently required to establish a debt through the courts (which can be over 12 months); and the difficulty in tracing unincorporated customers after they have left their premises.

It is, however, beyond reasonable doubt that bad debts will be at or above 2% of total NHH revenue for 2020/21 and 2021/22, and probably beyond.

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?

Present indications are that lower consumption customers *overall* have been more significantly affected (though there are obvious examples of significant effects on some larger customers - e.g. breweries, pubs and leisure venues. This to some extent also reflects the regional variations to which we referred previously – e.g. the concentration of the casual dining sector in London and the South East.

Within the smaller customer category, the SME sector has been particularly hard hit - e.g. hairdressers, personal care salons, private gyms. Therefore, while any form of uplift to the REC allowances will reflect a degree of existing discrimination and / or cross subsidy among default tariff customers and between default tariff customers and contract customers, this would be mitigated in part by separate uplift factors for Customer Groups 1 and 2, and by the more competitive market for contract customers.

Our payment terms are typically ✂ for large customers, and ✂ for small customers. Consequently, on average we would expect lower debt levels for larger customers, as the maximum level of debt is lower on individual invoices.

Although our categorisation of SME accounts and industrial / commercial accounts does not equate precisely with Customer Groups 1 and 2, the above picture is borne out by the following indicators:

- Of the c. ✂ increase in non-Direct Debit debt in the past year, SME accounts constitute ✂% by number and ✂% by value.

- Average SME debtor days have increased from ✂ in FY2019/20 to ✂ in FY2020/21 to date, whereas for industrial and commercial accounts they have increased from✂ to ✂.

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 think this almost certain, for the reasons given in answer to Question 1 above, referencing our previous response.

We currently estimate that bad debt in 2021/22 may exceed that for 2020/21, which would accentuate the effect of the different initial and subsequent customer sharing factors. However, we would not expect to be able to evidence this currently, as it will relate to smaller customers which are less likely to be able to be traced if they leave their premises.

<u>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'?</u>

We set out in our response to Question 1 of the November CFI that the crystallisation of bad debt occurs in five different ways, and over different periods of time. To take the example of insolvency, there are significant differences (including regional differences in their concentration) of customers with or without an incorporated legal entity. Identifying bad debt through insolvency of an incorporated entity is relatively straightforward. In other cases where it is not possible to trace a customer (which is more typical for unincorporated customers), write-offs are not normally effected until debt is statute-barred.

The application of the 2% threshold was stated in the 25 March 2021 Ofwat webinar as applying to each year, so that a high cumulative level of bad debt (at 5% in the associated illustration) could meet with no recovery whatsoever. This would drastically reduce the efficacy of the measure, and not give investors the necessary confidence. Moreover, it encourages overestimation and sharp rises and falls in the uplift, as it places too much reliance on the exact application of accounting standards and policies that are themselves flexible. While these can be used for estimation purposes, the recovery mechanism should reflect the actual economic and commercial impact on customers and retailers. The only way to do this is to focus on the cumulative impact.

This could work in in the following way:

- Year 1 – In (say) October 2021, take the total of Retailers' audited write-offs (or latest estimates) of bad debt for 2020/21 and calculate an uplift to the REC price controls from April 2022 to recover amounts above 2% of total NHH revenue.

- Year 2 – In October 2022, take actual write-offs for 2020/21 plus write-offs (or latest estimates) for 2021/22; check that the 2% threshold is still passed for total NHH revenue in 2020/21 and 2021/22 together and adjust REC allowance up or down accordingly.

- Do this until overall cumulative bad debt is back below the 2% threshold of cumulative NHH revenue.

This approach would make the regime easier to understand and operate, and remove possible accounting distortions, without blunting the incentive on retailers to realise and manage bad debt appropriately.

It would also align the trajectory of the customer contribution to that of the retailers' burden, and smooth out any sharp changes to the uplift. (The wording of 'an' initial estimation and 'a' later true up suggests a one-off adjustment to the REC and a single true-up at the next REC review. It also implies that there will be price controls in the next REC period and that they will follow their current form.)

Given that the realisation of bad debt will continue beyond the present REC price control period, and that we cannot pre-judge the structure of price control (if any), we also suggest that an identifiable bad debt recovery allowance is adopted, operating independently of the price control itself. That would enable it to be used both as an uplift component in the current REC price control and incorporated as appropriate in whatever regime succeeds the current REC price control.

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.

We note that, although Ofwat's preference is for recovery not starting until April 2022, it has not ruled out October 2021 (which we suggested in our response to the November CFI). If Ofwat were to base the recovery on actual write-offs this would largely obviate the need for an overly artificial regulatory mechanism with the correspondingly complex requirements of data collection, verification and estimation; inaccuracies; mid-year price changes and customer communication.

Retailers have already formed, or are forming, their view on bad debt write-offs for both 2019/20 (from January 2020) and 2020/21. These, together with estimates for 2021/22 could form the basis of an October adjustment to REC price controls, with true up against 2021/22 actuals in the following October. The challenges of mid-year price changes and communication would be offset by spreading the effect of the uplift on customers over a longer period. The earlier start to recovery would also reduce the level of working capital allowance that Ofwat would, under its proposals, otherwise need to make in the uplift.

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?

Yes, again for the reasons set out in our response to the November CFI; mainly those of simplicity, effectiveness and cost-effectiveness of design and execution.

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

Yes, as immediately above.

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).

The way the sharing factor is described does not properly recognise the impact on retailers and their customers. Retailers not only stand to lose 100% of the first 1% of bad debt above normal levels but have also had to incur higher costs than usual with lower revenues and margins – changes in volumes and changes in fixed charges have absorbed significantly higher levels of resource, but with no offsetting increase in revenue. In order to provide this extra support to our customers, we have already seen many customers' accounts yielding negative margins. For this reason, we propose that the sharing factor should be constant at 75% customer weighting.

In addition:

- It is not possible to predict reliably whether and when bad debt may fall one or the other side of the 3% threshold in any particular year. This would make the true-up process more complex and exacerbate the sharpness of any positive and negative adjustments year on year.

- There could be an incentive for retailers to use the flexibility afforded by the accounting standards to shift some realisation of bad debt to the year(s) where it is likely to be highest.

- The impact on customer bills is spread more evenly through a common sharing factor, especially if combined with an October 2021 start of recovery.

The incentive on Retailers to manage bad debt is not blunted by a higher initial customer ratio: given that retailers would be bearing bad debt 1% above historical levels , *and* a proportion of the excess, that proportion does not need to be as high as 50%. If the proportion were 25% that is still approximately ✂ our average debt collection cost, so at that level the incentive to collect remains strong.

We therefore consider that with this adjustment the scheme would better meet all three stated policy objectives.

<u>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?</u>

We strongly agree that separate uplifts for Customer Groups 1 and 2 are both fairer and better justified than a single overall uplift, for the reasons advanced by Ofwat. See further below.

In respect, however, of Ofwat's proposal that the bad debt recovery quantum for 2020/21 should include that in respect of *usage* post-January 2020, the normal lags between usage and billing and between billing and (non)payment are such that this cut-off makes its calculation complex and the resulting estimation arbitrary.

Since the pandemic will have impacted payment by customers of bills issued after January 2020, and thus prone to becoming bad debt, we suggest that the measurement of bad debt should be based on *billing* from 1 January 2020.

It will be clear from our observations on the period needed for the proper auditable recovery of excess bad debt that we see an enduring mechanism as logical and necessary. In respect of 'attenuation', to smooth price adjustments for customers over time, we assume that Ofwat proposes deferring some recovery of bad debt to later years. We suggest below that this is not warranted, given the other forms of inbuilt attenuation; and especially if Ofwat adopts the 'write-off' version of the mechanism that we propose.

If further attenuation is nonetheless imposed then there is an equally strong case for building in a working capital allowance for this element, and for this neither to be confined to bad debt costs during 2020/21 and 2021/22 nor to be limited to the period until the REC uplift takes effect.

<u>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?</u>

We would have expected standalone debt funding for NHH retail to be in the order of ✂%; and equity funding c. ✂%, prior to the pandemic. ✂ The cost of funding is therefore at a cost of the least-cost subordinated funding available, which will normally either be a subordinated loan or shareholder equity; or conceivably (but in our view less likely) this could be provided by mezzanine finance. Given the unusually poor profitability of the NHH retail sector- it is unusual for a NHH retailer to report a net profit – conventional external funding would not be available for bad debt. The credit metrics of NHH retail would suggest that required equity returns should currently be in the order to ✂-✂%, and the incremental cost of funding bad debt must be in this range.

<u>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.</u>

As noted above, we consider there is a strong case for two 'pools' with a separate REC uplift for each. This is for three main reasons:

- It goes some way to reflecting the differential effect of the pandemic on the two groups. As a result, it is fairer as between the group where bad debt is more concentrated and that where it is less concentrated, and as between Retailers whose customers are preponderantly in one group or the other.

- It reduces the degree of inherent discrimination both between those groups and between customers within those groups.

- The level of bad debt arising in each group might be expected to be proportionate to the average levels of bills in each group and therefore the sharing of the burden to be proportionate.

- Any alternative sharing of the burden would artificially shift the burden away from the customer group where margins are already too low, and worsen that position.

<u>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?</u>

The need to allocate artificially by provisions is obviated if the focus is solely on write-offs.

As noted above, the split by usage is both overly complex and inaccurate. The better measure is to split by billings.

Consultation Question 13. 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? 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 order to provide any meaningful degree of certainty to investors a commitment to recovery of cumulative written off bad debt above the 2% threshold is necessary. Although this could mean a period of several years of recovery, it offers not only certainty to investors but assurance to customers (and Ofwat) that the mechanism is recovering no more than the 'excess' bad debt that retailers are actually incurring. This should subsist until the cumulative bad debt falls below 2%.

Given that retailers would be bearing: (i) bad debt at twice the historic level; and (ii) significant lags between estimation or write off and recovery, we do not see further 'attenuation' of recovery as warranted. In any event these factors, together with the lack of incentive on retailers to incur the cost of write-off prematurely, will both reduce the absolute level of the burden on customers and give rise in themselves to a high level of attenuation.

Castle Water Limited
6 April 2021