everflow water

Bad debt consultation response
April 2021

Summary response

We would like to thank Ofwat for continuing to progress with the question of Covid-19 bad debt recovery in a timely way and for this further opportunity to comment on its latest thinking.

We recognise the way in which Ofwat clearly heard and responded to the key concern we raised in the January CFI, where we highlighted that a one-year price increase on the REC could harm competition and put independent retailers with a majority of contracted customers at a disadvantage.

There are still some aspects of Ofwat's proposed approach to debt recovery that we are concerned about, so we are pleased to have the opportunity to respond to this consultation. Although the amendments to REC pricing will not directly impact on Everflow Water in the same way as other retailers, the reality is that our debt recovery potential is significantly affected by the extent to which out of contract prices are adjusted to recognise the large debt burden created by Covid-19; a significant proportion of which is likely to be unrecoverable.

For the avoidance of doubt, we are clear that Ofwat's primary purpose in providing for the recovery of excess bad debt is to protect customers; particularly by ensuring the market is not destabilised by systemic retailer failure. We have also previously urged Ofwat to consider the importance of promoting competition as part of serving customers' best interests. We are concerned that Ofwat's approach to bad debt recovery effectively constitutes further price control in a deregulated market (because out of contract price caps affect all customer contracts; especially where the cap is low). If bad debt cost recovery in the coming years is heavily regulated, this will undoubtably reduce the savings all retailers are able to offer to prospective customers, thus reducing competition.

To assess whether the recovery of excess Covid-19 bad debt will achieve the desired objectives in a fair and balanced way, we suggest the proposals need to be considered as a package. When combining the aspects of the proposals under consultation (see our worked example in Appendix 1) we find the overall picture to be imbalanced. By our calculations, less than 20% of the excess bad debt suffered by retailers because of Covid-19 will be recoverable. We therefore believe the proposed approach does not go far enough to serve customers' interests as summarised above - beyond a short-term cost saving.

The key factors that we believe need adjusting to improve the balance are:

- The proposed exclusion of Covid-19 bad debt costs relating to service delivered before January 2020;
- The 2% threshold determining the 'excess' level potentially being applied over multiple years; and
- The sharing of excess bad debt costs with customers.

The first factor is really about measuring or defining Covid-19 bad debt in line with international accounting standards, to avoid a situation where retailers bear a significant proportion of excess Covid-19 related bad debt on the basis of taking a non-standard approach to bad debt provisioning. Our answer to question 3 covers this in more detail.

During the webinar Ofwat hosted on this bad debt consultation, a retailer asked whether the application of a REC increase over multiple years would mean the 2% threshold for determining 'excess bad debt' would then apply over multiple years. Ofwat said that it considered 2% an 'anomalous' level of bad debt which a prudent retailer should be prepared for. We therefore assume that as an 'anomalous' level this would only be applied in one year. If a 2% threshold was applied over several years this would put a serious burden on retailers, which could lead to multiple retailers failing. It would also not be reflective of a fully functioning competitive market, where if costs increased over a number of years, this would result in price increases.

We set out why we think all excess bad debt above the 2% threshold should be split 75% / 25% between customers and retailers in our answer to question 8.

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?

There has been no material change to our bad debt provisioning. As we said in our response to the CFI in January, [redacted] We do not expect the level of bad debt from the year 2020/21 to crystallize until October 2021 at the earliest.

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?

Our response to the CFI in January highlighted that the proportion of aged debt attributed to customers grouped by consumption levels has not changed significantly by comparison with the pre-Covid debt position; and that all of our customers appear to have been impacted on an equal basis by Covid-19. As before the pandemic, a high proportion of the customers we have in arrears **numerically** speaking are low consumers, but in our case it is the larger SME businesses in arrears that account for the majority of the total **value** of aged debt.

Our data below shows that whilst the smallest customers do not represent the majority of aged debt at this point in time, the level of aged debt compared to spend by customer group illustrates the fact that smallest customers have been most significantly impacted by the pandemic. Aged debt is disproportionately higher for the <0.5Ml segment compared to medium and large

businesses. This fits with the anticipated level of bad debt seen in the CFI responses, where the highest percentage of bad debt sits in the smallest customer group of <0.5Ml.

Aged debt analysis by customer size (consumption group)

Jan '21			
Bandings	% of aged debt value	% of overdue customers	% of revenue for Q1 '21
>50Ml	■	■	■
0.5-50Ml	■	■	■
0.5Ml	■	■	■

Larger businesses are inherently more robust and able to withstand economic shocks, whereas smaller businesses are less sophisticated, and the frequency with which smaller businesses fail is higher than at the larger end of the spectrum, with the five year survival rate for new businesses sitting at just 42.5% in 2019. As such, the aged debt for smaller businesses is more likely to crystallise into bad debt than the aged debt for larger businesses. Wider access to capital will also contribute to the lower failure rates of larger businesses.

Our conclusion from the data is that smaller businesses have been affected more significantly, and that the level of bad debt that will arise will be higher for smaller customers.

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?

We strongly agree the impacts of the pandemic will continue to be felt throughout 2021/22 and very likely beyond. We welcome Ofwat's recognition that the economic impact of the pandemic is likely to have been delayed by unprecedented levels of government support. We think it is likely that the most testing period for businesses is yet to come, following the ending of government support. We share the view of many experts that it is likely that more businesses will fail in the coming year than in the past year of national lockdowns. To quote one source: "The view of many experts on corporate insolvency ... is generally that business failure rates will pick up sharply [in 2021] as initiatives like the government's furlough scheme come to an end".

The British Chambers of Commerce reported on March 25th, 2021 that:

- 26% of firms describe their current level of debt as either 'unmanageable' or 'high and manageable'. This rises to 32% for hospitality and retail firms.
- 55% of respondents say they are looking to access finance over the next 12 months. Of these, almost two thirds (63%) say this is to support their cashflow.

Hence, we do not think it would be appropriate to set an 'end date' for the period over which Covid-19 related bad debt is measured. This should be monitored over time.

'Start' position

Ofwat has not asked for views on the start point from which bad debt should be measured. We would like to stress that while it would be appropriate to set a **baseline date** from which to measure bad debt costs; the suggestion that bad debt costs associated with services provided prior to January 2020 should be excluded would not be in line with standard international accounting practices. This would be very difficult to implement in practice because standard bad debt provisioning practice does not make this separation and retailers would need to develop a process for this. This would be in contradiction to Ofwat's statement: "We therefore consider that a Retailer's accounting estimates which are calculated using relevant accounting standards should be used to derive initial bad debt costs."

As we explained in January's response to the CFI, under both IFRS 9 and FRS 102 bad debt is recognised when there is evidence that a customer or group of customers will not pay, based on when that evidence arose, rather than relating to when the service was provided. The recognition in both cases is based on observable data that future cash flows recovered from outstanding debt is lower than previously expected. We do not see why anything other than well-established accounting standards should be used to define bad debt costs. The recognition in both cases is based on observable data that future cash flows recovered from outstanding debt will be significantly reduced by changes in external operating conditions.

Furthermore, this proposal (which is set out on page 22 of the consultation) appears to be in direct contradiction to the following paragraph (on page 23), which recognises that debt collection processes take several months; at least in part because customers are given time to pay - including the opportunity to repay their debt on a payment plan. As Ofwat says, in "**any** financial year" it will take "at least six months, and perhaps more accurately, one year" for it to become clear that a debt is unrecoverable. In other words, when a retailer measures debt at a particular point in time, this will normally relate to services delivered 6-12 months previously. **A significant proportion of aged debt in March 2020 that turned bad as a consequence of the pandemic will have related to services that were delivered between March 2019 and March 2020.** Retailers may distinguish the proportion of aged debt that became 'excess bad debt' as consequence of the pandemic by comparing this with a baseline bad debt level. We would be in a position to use our December 2019 audited figures as a baseline.

The exclusion of bad debt which relates to services delivered prior to January 2020 could significantly reduce the proportion of excess Covid-related bad debt that retailers are able to recover. In addition, an attempt to separate bad debt provisioning based on when services were delivered would constitute an additional non-standard accounting process which would be complex and time consuming to implement – which would not be in line with Ofwat's guiding objective to provide a simple and efficient solution to the problem of excess bad debt.

Note: The complexity involved in attempting to separate out debt relating to services delivered pre- and post- January 2020 means that we have not been able to quantify the total value of this excess doubtful debt.

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'?

We agree with the proposal.

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 do not have a strong view on this. As we said in our January CFI response, the goal of establishing how excess bad debt will be recovered was always to give lenders confidence that a mechanism exists. The exact timing of when this is introduced is secondary to the issue of certainty – assuming that the value of the bad debt that is recovered would be the same regardless of timing.

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?

We agree with Ofwat's proposal to use a REC price cap adjustment over a minimum period of two years, as this seems to be the simplest option. Adjusting the prices cap over a longer period will be better for customers and better for competition, as this will enable retailers with contracted customers to adjust their prices in line with out of contract rates. We may even see increased customer engagement with the market, as efficient retailers who have navigated the pandemic effectively may be able to offer larger discounts by comparison with out of contract rates than before.

However, we are very concerned that spreading the recovery of excess bad debt over multiple years could be applied in a way that reduces the overall amount of excess bad debt recovered in the market. This was queried during the webinar Ofwat hosted on this bad debt consultation, when a retailer asked whether the application of a REC increase over multiple years would mean the 2% threshold for determining 'excess bad debt' would then apply over multiple years. Ofwat said that it considered 2% an 'anomalous' level of bad debt which a prudent retailer should be prepared for. If 2% (or 1% over historic levels) is an 'anomalous' level then it follows that this would only be applied in one year.

If a 2% threshold was applied over several years this would put a serious burden on retailers, which could lead to very little recovery of Covid-19 related bad debt; or no cost recovery if the 2% threshold was not reached in any single year. We are concerned that this could cause multiple retailer failures. It would also not be reflective of a fully functioning competitive market, where if costs increased over a number of years, this would trickle through to price increases over time. No business would be able to continue bearing excess costs for an indefinite period; but this is especially true in the water retail market where margins are very small as a proportion of revenue.

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

We mostly agree with Ofwat's assessment of options, although reduced certainty stemming from the use of averages may not be a gain. If retailers with the highest levels of bad debt are able to increase their prices to recover their excess bad debt, market forces will provide an incentive for retailers to consider their pricing carefully (as they would in any competitive market). Higher price increases will encourage customers to switch away from poor performing companies while better performing retailers will be likely to win more customers.

There is a potential risk associated with the preferred option which has not been identified in the options appraisal, which is that retailers will clearly be incentivised to pursue more aggressive debt recovery strategies. It may be worth considering debt recovery performance alongside how well companies have performed on providing customers will support at their own cost - in the form of Covid-19 Repayment Plans. It is likely that companies that have taken a more supportive approach towards customers will incur higher bad debt costs. In our case, approximately [redacted] of our aged debt is currently being recovered through payment plans.

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 objective of allowing retailers to recover their excess bad debt costs is to protect the interests of NHH customers in the short and longer term, including from the risk of systemic retailer failure. We agree that the intervention should not disincentivise retailers from collecting debt – which essentially means the intervention needs to strike an appropriate balance.

In our response to the January CFI we proposed that excess bad debt (over a 2% threshold) should be split 25% / 75% between retailers /customers. This was a 'cost referencing' rather than a 'cost reflective' proposal, given that the typical cost of debt recovery is around 12% of the value of the debt (this is a typical rate charged by accredited entities in the market). We felt that our proposal that retailers could bear 25% of excess bad debt was balanced: being generous towards customers, while providing a strong incentive for retailers to collect debt rather than allow it go bad. It would mean that debt which is unrecoverable would cost retailers twice as much as debt that was recovered. It should be noted, though, that even with a 12% / 88% split, retailers would always be incentivised to recover debt themselves rather than wait for the price cap to be lifted as the timing of debt recovery is important for cashflow and – assuming Ofwat proceeds with the use of averages to determine the cap on REC price increases – all retailers will be keen to ensure their bad debt does not exceed the average market level.

We do not agree that excess bad debt between 2% and 3% of revenue should be split 50% / 50% with customers, as this would not strike an appropriate balance. We also do not see a good reason for a 'stepped' approach to the sharing of excess bad debt. This creates unnecessary complexity, which is not in line with the objective of implementing a simple solution. It also creates a perverse incentive for retailers to let their bad debt increase to 3% +, which is not in line with the objective to promote efficiency.

We maintain our proposal that 25% / 75% is a balanced split for all excess bad debt (above 2%); especially given that retailers are already being asked to bear 1% of excess bad debt (in some

cases more because of good historic performance), and that some retailers will not be able to recover the bad debt they incur over the market average level.

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?

We broadly support the proposed approach with one exception. In line with our response to question 3, we do not support the proposal to split bad debt by when services were provided. This would constitute an unnecessary and burdensome complication, which could also lead to significant exclusions of excess bad debt that would under standard international accounting practice be justifiably considered Covid-19 related bad debt.

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?

The financing costs associated with (1) the additional level of aged debt suffered by retailers in the market as a result of non-payment, (2) the requirement that retailers should be supportive of customers at a time when cashflow is tight, and (3) the additional financing burden to meet the working capital gap caused by the higher bad debt costs that are being incurred by retailers are significant.

The water retail market inherently requires significant scale to access the rates that Ofwat has historically considered to be efficient.

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.

Given the cause of excess bad debt, and the way that the pandemic has impacted particular markets for reasons beyond their control, we are still not convinced of the ethics of further increasing the disproportionate impact of the pandemic on those sectors most affected, by expecting them to pay for the excess bad debt. That is not to say that those customers who were not impacted as badly should pay a higher share of bad debt recovery charges; we feel the pain should be shared across all customers to minimise the impact. This would be consistent with the way that retailers (many of which are small businesses) are being asked to bear a significant proportion of the impact of the bad debt levels resulting from the pandemic.

We therefore do not support the idea of pooling debt on a granular level, such as by sector (e.g. hospitality sector paying a surplus) but we do think that there is logic in pooling both measurement and recovery of bad debt by the broad customer groupings Ofwat proposes, given that different levels of price regulation already apply to these groupings, and that these broader groups have contributed differently to the bad debt issue (see question 2).

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?

We recognise that the provision of data will be necessary for setting the REC price cap adjustments. The only concern we have is around the provision of bad debt data split by when the services were received. See our responses to question 3 and question 9.

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?

We strongly support Ofwat's proposal to commit that the REC price increase should be spread over a minimum of two years. This will both smooth the impact of price increases on customers and avoid putting retailers will a majority of contracted customers at a competitive disadvantage.

APPENDIX 1: Worked example showing how the overall package will impact retailers in practice

We think it is helpful to combine the aspects of the approach under consideration in combination through a worked example, to assess whether the overall picture looks balanced. There are various scenarios which could be considered, from a worst-case scenario where the average bad debt rises above 5% to best case where it does not exceed 2%. We have opted for what is in our view a reasonable mid-range scenario.

Worked example showing what the current proposals would mean for the average retailer:

		2020/21 only		
a	Revenue		£200m	
b	Historic level of bad debt	1.0%	£2m	
c	Outturn level of bad debt (where industry avg level = average retailer level)	3.4%	£6.8m	
d	Bad debt arising from services delivered pre 2020 (estimate)*	0.5%	£1m	
e	Outturn level of bad debt after exclusion of **d**	2.9%	£5.8m	
f	Additional 1% of debt absorbed by retailer	1.0%	£2m	
g	'Excess bad debt'	0.9%	£1.8m	
h	Recoverable 'excess bad debt' (after 50/50 split)	0.45%	£0.9m	
	Total Covid-19 related bad debt (c - b)	2.4%	**£4.8m**	
	Amount absorbed by retailer (d + f + h)		**£3.9m**	**81.25%**
	Amount recovered by retailer (h)		**£0.9m**	**18.75%**

*The cost of excluding bad debt arising from services delivered is potentially greater. In this example if 'excess bad debt' includes **d** and is 1.4% of revenue [£2.8m], this would breach the 3% threshold for retailers to recover 75% of the excess. 75% of £2.8m is £2.1m. £2.1m is £1.2m greater than **h**, so in this example a further £1.2m is not recoverable as a consequence of excluding bad debt arising from services delivered pre-2020.

Alternative more balanced approach

a	Revenue		£200m	
b	Historic level of bad debt	1.0%	£2m	
c	Outturn level of bad debt incl bad debt arising from services delivered pre 2020 (where industry avg level = average retailer level)	3.4%	£6.8m	
f	Additional 1% of debt absorbed by retailer	1.0%	£2m	
g	'Excess bad debt'	1.4%	£2.8m	
h	Recoverable 'excess bad debt' (after 75/25 split)	1.05%	£2.1m	
i	Irrecoverable 'excess bad debt' after 75/25 split (retailer efficiency incentive)	0.35%	£0.7m	
	Total Covid-19 related bad debt (c - b)	2.4%	**£4.8m**	
	Amount absorbed by retailer (f + i)		**£2.7m**	**56.25%**
	Amount recovered by retailer (h)		**£2.1m**	**43.75%**