SUMMARY

Thank you for the opportunity to respond and to help to identify solutions in the long-term interest of all customers and the market.

The proposal for a market-wide uniform uplift sounds like a positive idea, however we are disappointed to note that the review is against the REC because a proportion of the market is excluded. We see this as being detrimental because it unfairly penalises the deemed contract segment of the water retail market and fails to support all Retailers. We note with interest, from the consultation response that 3 Retailers supported the REC and 4 Retailers opposed the REC methodology (5.3.1 page 27 & 28 Business Retail Market Customer Bad Debt – Consultation). In section 5.3.3, 3 Retailers supported a Levy being introduced, which reaffirms the complexity of the challenges faced and so the Retailers are evenly split on a decision. We note that our position has shifted and leaning more towards a levy now that we understand in more detail about the proposal from the Regulator.

[redacted]

In responding to the consultation, we have tried to identify the framework of solutions for OFWAT to consider and our key opinions on these proposals are:

- A 2% bad debt cap exceeds our own experience and we prefer a mechanism that fairly rewards a good retailer, with the regulator confirming that the thresholds do not accumulate over multiple years.
- A more expansive tariffs scheme should be introduced, which protects paying customers and gives more flexibility to Retailers to charge poor payers. Immediate payment on switching is also required.
- A method of bad debt recovery must be consistently fair to customers and not too onerous whilst maintaining a level playing field for all Retailers and we would prefer that a levy is implemented.
- Timely conclusion to the consultation and interim measures to alleviate short term difficulties are vital.

We trust you will find our responses to the RFI interesting, constructive and positively challenging. At PWS we want to ensure that all customers are protected including those that pay their bills even in challenging times. Therefore, we promote protection for those willing to pay from unnecessary cross subsidization and welcome the opportunity to further this dialogue with the regulator and the market.

Questions

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?

Note in reviewing our response to this question, at the timing of preparing the response in late March 2021 there remains uncertainty regarding our financial provision assessments for financial year end 2021/22.

[redacted]

[redacted]

[redacted]

[redacted]

At this time, we are assessing our need for further provision relating to COVID-19.

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?

Our experience shows that the customers impacted by COVID-19 include the following industry classifications: public houses, restaurants, leisure and retailers. We have seen volume consumption across more categories but varying payment trends in the afore mentioned categories. Our most recent management review had provision [redacted] in total.

	% of total provision
Leisure	21%
Retail	17%
Pubs / Restaurants	16%

These three categories represents c53% of the total provision requirement in the business. The customers mix between Group 1 and Group 2 as part of the REC tariff volume consumption brackets.

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?

We agree it is that the impacts of the pandemic will continue during 2021/22 and continue beyond this time. The related issues which we envisage will potentially drive the timing of bad debt costs become evident when:

- The roll out of the vaccine and the occurrence of virus strains which slows the economic recovery and further national lockdowns
- The government funded financial support given to UK businesses has provided short term relief mechanisms during 2020. However, it is possible that the true financial consequences in terms of businesses that are no longer viable has been delayed due to the length of government initiatives.
- Bad debt cost crystallises when accurate meter reads are available and all disputes relating to leak allowances are explored. With meter read completeness being lower, the timing could be longer than the consultation expects.

It is also worth noting that a complex insolvency of Lehman Brothers in 2008/09 is still not fully resolved. Therefore, the bad debt costs could run into 2026 /27, assuming a backlog of insolvencies of smaller companies have been reviewed and the tidy up process complete.

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'?

It is our preferred treatment that bad debt costs assumption included in our management accounts is used. This is beneficial because it enables:

- Allows Retailers management to understand and communicate the broader issues to stakeholders such our Board and our auditors.
- Saves duplicate or introducing complicated calculations or introducing new processes
- It is clear and transparent, the regulator will have some assurance because these numbers are audited retrospectively by our financial auditor

We have concerns regarding true-up mechanisms, including:

- There are customers who we don't yet know have become insolvent, therefore recovery of intended tariff increases should assume an allowance for 'failure to collect'.
- The impact of attrition of REC customers whilst the mechanism is in place means that the recovery profile will be less than intended.
- With these issues in mind, the regulator should consider that the true-up mechanisms will require either further uplifts or the revised REC continues for longer than the current 2 years envisaged in the consultation.

We consider that the provisioning and future bad debt write offs are the most reliable estimates on which the regulatory protections should be based.

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.

Yes, we believe implementing from April 2022 gives time for us to review the consultation fully and deal with unanticipated consequences. Tariff changes are performed annually, at the start of the financial year. A mid-year change means much of this work will repeat for customers within the REC.

It probably is also more palatable for customers as having a price increase part way through the year may increase traffic/complaints or may require correspondence (and cost) explaining why. It is potentially a hard to explain the rationale

Ultimately it's a balance of the upside of higher Retail revenue for 6 months against the challenges to communication a mid year adjustment.

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?

As stated in our previous consultation response, an application of the REC is the simplest approach to provide a consistent approach. We note, in the intention for a *market-wide tariff increase* as proposed in the consultation. With this in mind, we are surprised the regulator has opted for the REC only. We had anticipated that the regulator would opt for a levy, applying a pooling arrangement managed by the Retailers (without the need for Wholesalers), with a contribution into the central fund. This seemed to be fair to all customers. We don't think it is right that a certain parts of the market subsidises some customers.

In the consultation, we believe the implementation costs are similar and ensures fairness between customers. An increase in percentage uplift on wholesale charges are not guaranteed to be uniform between customers therefore a uniform increase to fixed charges, split across the regulatory consumption brackets would make sense. With the noted priority to minimize the risk of systematic Retailer failure, implementing a levy goes further to support the market and is fairer to customers.

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

Firstly, we agree with the options and agree with the stated principles particularly to protect customer interests, efficiency and provide clarity. We believe a levy better aligns with those because it promotes fairness, protecting (all) customers and address the concern of systematic risk of retailer failure.

We agree with the summary of the options but fundamentally option 1, with an amended REC is not fair to all customers (or Retailers).

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 regulators original stance, that a well run retailer ought to be able to absorb 2% of bad debt as a percentage of sales. Any increase above 2%, is now shared 50%-50% and above 3% shared 75%-25%. We cannot understand what has caused this change of position and adds an increased burden on Retailers above any 2% threshold.

With reference to 6.4, we agree that Retailers should bear responsibility for our business and the debt risk should reside with the Retailer. However, we disagree with the point that wholesaler is taking its share of the risks in the market, capturing the risk of Retailer default. The margins and credit protection are significantly in favour of the wholesalers compared to Retailers. To date the bad debt exposure in real terms will be Tor Water and potentially customers operating on self-supply and nowhere near the thresholds of bad debt that the Retailers are expected to absorb. With reference to the Scottish market, the issues of the consultation are not being discussed because the normal margin in Scotland far exceeds England and therefore the time to recover of bad debt shock is far quicker. As we note in our introduction, the bad debt charge for last year was 5 times our expected operating profitability in that same year.

We maintain our view that the thresholds proposed are arbitrary and go far beyond the assumed allowed cost to serve.

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?

We believe the regulator should include the following aspects of bad debt costs incurred by Retailers:

- The bad debt cost charged in the profit and loss, as well as the subsequent write offs
- The interest costs in supporting past due debtor balances
- Support of the extra bad debt collection

Our interpretation of the consultation, with a uniform uplift means that it is likely that the fixed element of tariffs will be increased. The application of percentage increase will add administrative burden and reporting to assess the recovery of REC changes on a variable basis.

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?

With reference to 7.3.1, as stated in our last response:
7.3.1 (2) – our December 2020, past due balance was [redacted] (Average in the [redacted])
7.3.1 (3) - we estimate that the additional costs associated with debtor collections is in the region of £0.4m per annum.

We believe the following aspects should be considered for the cost of the excess working capital:

- Interest rate: Either a market wide uniform interest rate, potentially the effective interest rate in the market based on the review of statutory accounts of retailers, an agreed rate of libor + 5% (or Sonia + 5% once libor is replaced)
- The amount of average debt which is past a certain threshold for past due, say 90 days past due over the proceeding 12 months.
- A future financing charge = 5% x debt balances greater than 30 days past [redacted]

Considering £1.66m of financing cost, as well as the bad debt collection charges of £2m which a broad indication of the excess financing costs incurred in a single year.

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.

In the interests of being fair to the customers, the proposed pooling seems a sensible starting point for a revision, providing any amendments are proposed within the parameters of our IT capability.

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?

Pennon Water Services does not have any particular concerns regarding data set A. On data set B, relating to the financing of working capital. The regulator should be minded to recall that the opportunity cost, as well as the absolute financing cost in our profit and loss. It is worth noting that our budgeted shortfall in 20/21 is c [redacted] increase in debtors and therefore lower cash collections in the year. Our year on year interest cost is flat, but fails to consider what we are targeting to achieve and actually our interest costs should have fallen [redacted] in the year.

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 responding to this question, we are mindful that the regulator has confirmed its intention to review the REC considering the existing market weaknesses and develop improvements to the REC. With that in mind the changes to REC and potential price caps should be expected to last for at least 2 years, with the evolution of the REC as we envisage the end of the *Price Caps* should coincide with the introduction of REC v2.0. In doing so, the communication and messaging to customers should reflect the strategic priorities at that time.