Ofwat
City Centre Tower
7 Hill Street
Birmingham
B5 4UA

Email to covidbusinessretailmarket@ofwat.gov.uk

6th April 2021

Dear Sir

Business Retail Market – Customer Bad Debt 2021 consultation.
UKWRC high level response.

Our members will be responding to Ofwat directly on issues specific to them. However, as UKWRC we would like to highlight the following key issues that affect all our Retailer members.

Retailers now appear to be expected to bear a greater proportion of excess bad debt costs than first anticipated. Originally there was discussion around a cap of 2% in relation to Retailer exposure. This has now developed into considerably more than 2% and in reality, customers will fund very little of the excess exposure. Retailers are not in agreement on all matters covered by the consultation, but we generally agree that the recoverable amount looks likely to be significantly reduced by the following factors.

<u>Excess Bad Debt Scope</u>

To encourage the suitability of Ofwat's proposal, we feel strongly that retailers' bad debt P&L charge should be used as the baseline for the mechanism. We disagree that separating out bad debt based on when services were delivered or billed should be factored into the mechanism. This adds complexity and could lead to significant exclusions from what would, under standard accounting practice, be legitimately classed as Covid-19 related bad debt. A higher proportion of debt from prior to January 2020 will have gone bad due to Covid than otherwise would have done. The way to measure that is to look at bad debt P&L charges before Covid and consider that a baseline.

Our suggested approach would be entirely consistent with standard accounting practice. As long as an appropriate calculation is undertaken prior to March 2020 for all debts outstanding at that point, any movement between the above benchmark and the provision at March 2020 could reasonably be attributed to Covid - the key difference being the probability of default, which increased as a result of the pandemic, thus resulting in increased bad debt levels within the market.

Proposed Mechanism

Whilst there is no current consensus between Retailers on the appropriate mechanism to address this issue, there is uniform concern around the single communal REC uplift (and ensuing true-up) based on average bad debt costs between all Retailers. The use of a single aggregated figure will effectively disregard the particular circumstances experienced by individual Retailers. This will create 'winners' and 'losers' within the market, as it will make Retailers dependent on their relative performance compared to others who may be facing different challenges. As such, there is a potential threat that some Retailers may lose out not based on 'performance' but on factors outside of their control such as their customer mix and geographic variation in lockdown rulesets.

Retailers are of the view that for the smallest customers, there have been insufficient margins to date to compensate for the bad debt risk. In the light of increased bad debt costs associated with SME customers, this will be further exacerbated, meaning these customers become even less attractive to Retailers, so that even if these smallest customers did want to switch, many Retailers would be reluctant to, or would not, take them on. This further reduces choice and opportunity for that class of customer. It could also result in Retailers being put under further pressure and creating the potential for systemic Retailer failure.

Excess Bad Debt Liability for Retailers

The level of excess bad debt costs Retailers will be expected to fund in the current plan remains unsustainable and does not sufficiently address the risk of systemic Retailer failure. Following initial discussions of around a cap of 2% in relation to Retailer exposure, the current proposal has now developed such that Retailers will still continue to bear considerably more than 2% in reality. Customers will fund very little of the excess exposure because Retailers will bear an additional 50% of costs where costs are 3% or lower and an additional 25% where costs exceed 3%. We suggest that beyond 2% of revenue, Retailers should only be expected to bear a proportion of the excess bad debt that is equivalent to the costs of debt recovery. A number of Retailers will provide evidence on the costs of debt recovery in their individual responses.

Furthermore, following the webinar Ofwat stated that 2% of revenue was an appropriate level of excess bad debt that a prudent retailer should be prepared for in an 'anomalous year'. It therefore would not be appropriate to expect Retailers to bear 2% each year before any cost sharing mechanism would apply. We take the view that it should only apply in the first year, with the excess being everything over 1% (or historic levels) in subsequent years.

Conclusion

As currently presented, Retailers are concerned that the proposals are not sufficiently protecting the interests of non-household customers because as a package they do not offer sufficient certainty and support to Retailers. Retailers are also concerned that the proposed mechanism further exposes Retailers and therefore customers to the risks related to increased bad debt.

We hope this is useful. As always, we are happy to discuss our comments further.

Yours faithfully

[redacted]

Phillip Mills
Chair
UK Water Retailer Council