Water plus
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Dear Ofwat,

Customer Bad Debt March 2021 Consultation

Thank you for giving Water Plus the opportunity to provide its views on the issues raised by this consultation.

Our responses to each of your 13 questions are provided on the subsequent pages, and our salient points are as follows:

- We are appreciative of Ofwat's recognition of the need to provide Retailers with a mechanism to recover excessive bad debt costs, incurred as result of Covid, which were never envisaged when setting the regulated price control caps to date.
- The urgency of relief for Retailers is a priority, however, on balance we agree with your minded to implementation date of April 2022 as a mid-year (October 2021) implementation is likely to lead to significant customer confusion and dissatisfaction at a time where they would have only recently been released from trading restrictions - or may still be encountering them. Additionally, a mid-year change to tariffs may be very problematic, time consuming, and costly for Retailers to implement, negating some or all of the marginal additional benefit of trying to successfully implement bill changes ahead of the annual tariff setting timeline.
- The excess bad debt costs need to be determined by reference to increased levels of uncollectable debt, above the historical norm, as a result of Covid. The current minded to proposal looks to restrict the excess debt calculations to a charging period starting January 2020, but this excludes earlier charged for periods that would normally be expected to be collected, even if it took a year or more, that might not now be possible because of expected and unprecedented high instances of Covid caused business failures.
- 'Normal' recession-type scenarios, that you state an efficient and prudent Retailer should have planned for, do not occur every year and therefore when considering the threshold above which you are minded to consider offering some protection to Retailers, the additional (currently minded c1%) above historical norm bad debt to be absorbed by Retailers before the sharing threshold applies should only apply for year one of any multi-year approach.
- We would recommend that the 50:50 risk share proposal is removed and instead the 25% Retailer vs 75% Customer share of excess bad debt cost should be applied as soon as 2% bad debt has occurred.
- We believe there is strong merit to separating out the 0 to 0.5Ml and 0.5 to 50Ml customers segments into two separate pools, with separate uplifts for each group of customers. The use of a single 'average uplift' would not be appropriate given the material likelihood of variance between the profiles of the two groups, with this

averaging not only creating an effective cross-subsidy of risk but also potentially raising questions of anti-competitive pricing.

- As set out in our earlier responses, the REC injection approach provides Retailers with opportunity to earn additional revenue. It does not however ensure that individual Retailers who have suffered excess bad debt will be able to recover calculated theoretical amounts. The market conditions e.g. levels of competitive pricing and switching as a result of the REC injection will determine how much of the excess bad debt incurred by each retailer is offset by the additional revenue opportunity. If levels of excess bad debt (once determined) are modest, individual customer prices will not increase to a level likely to significantly stimulate market activity and therefore, the approach may not be significantly disadvantageous to any individual Retailers. However, as levels of incurred excess bad debt increase, those Retailers who will most need the 'protection' opportunity to increase tariffs are at most risk of losing customers to competitors, thereby not recovering the historical bad debt the mechanism is supposed to be providing 'protection' for. Furthermore, the Retailers will have reduced customer books and therefore less contributions to profit going forwards, further exacerbating the risk of Retailer failure.

- Further to the above, we would challenge the appropriateness of utilising enhanced competition alone (i.e. increasing contestable revenue) as a response to addressing the issues of historically regulated pricing. Most customers in the market remain on 'deemed contracts' and have not effectively operated as a 'competitive market' to date. The tariff structures relevant to these inherited customers have been set at the price cap established within the REC, thus limiting the assessment of the bad debt risk for these customers. As revenue recovered to date from this customer base has been subject to the regulated tariffs & is subject to any additional bad debt adjustment Ofwat makes (which may effectively be competed away), the Regulator will have enforced a loss making position on incumbent Retailers with deemed customer books. As incumbent Retailers cannot decline to service customers at a loss making REC price cap, and must operate as a provider of last resort, a 'competitive' solution cannot be considered as reasonable to address the inadequate cost allocation established to date.

We would be more than happy to discuss these points in more detail, so please do not hesitate to contact me.

Yours sincerely,

Lewis Gross
Chief Financial Officer

Responses to Consultation Questions

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?**

   Using the available information to date, our current estimates of bad debt for Water Plus are shown below. Stated within our audited accounts for the year ending 31 March 2020 was a [Redacted] increase in bad debt provision required at that time as result of our forecasts of the adverse impact of Covid on the ability of us to successfully recover outstanding debt.

   As your consultation question does not ask about 2019/20, we have added this additional Covid related bad debt charge to the 2020/21 values* below. This will aid comparability with other Retailers who may have made zero or relatively modest provision for Covid within their 2019/20 accounts and therefore likely to have a comparatively larger charge in 2020/21.

   We would further note that the omission of a reference to 2019/20 data from this question is itself surprising given many accounting standards will require a forward looking assessment of credit losses (Expected Credit Losses as opposed to Incurred Credit Losses).

[Table Redacted]

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?**

   We expect smaller customers to have been more impacted by Covid lockdowns than larger customers, for example large usage customers will include a high proportion of manufacturing and distribution sites which have not been forced to lock down, whereas non-food Retailers and other small sites such as hairdressers have been forced to lockdown. Many small offices have also been closed while staff have been encouraged to work from home.

   At present, we do not have full segmentation of bad debt by consumption bands. As a proxy, for the 'up to' and 'greater than' 50Ml per annum usage customers, we have utilised our "Non-Key" and "Key" segments (which we use for provisioning purposes) respectively. All our "Key" customers will be in the >50Ml group. As evidenced by Table 1 above, there is a clear distinction between bad debt as a percentage of revenue above and below this volumetric point. We are looking to further disaggregate the bad debt charge within the up to 50Ml band, but this more granular analysis is unlikely to be available before October 2021.

   We would expect a higher propensity of default customer (rather than those who have moved onto explicit contracts) debt to go bad, because those who have engaged with the market and switched off default have tended to be larger customers and, as mentioned earlier, we expect these businesses to be more resilient to the Covid financial pressures.

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 that the impacts of the pandemic, including the associated bad debt costs, are highly likely to continue to accrue into the future. It is not yet possible to know how long these impacts on bad debt will continue, or how long it will take to understand these bad debt impacts. Any potential timeline will depend on a variety of things such as when lockdowns and business restrictions end, when government support measures (e.g. furlough schemes) are withdrawn, and how soon we identify/are informed of customer business closures.

As a result of this uncertainty around future impacts of the on-going pandemic, it is important that whilst any mechanism provides clarity and certainty to market participants it also remains sufficiently open and flexible to adjust to any significant deviations from initial expectations. As discussed later, in response to question 13, we believe it appropriate, at this early stage, for the process to not have a set end-date, to ensure the mechanism can sufficiently react to any future significant changes.

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 that bad debt will take time to manifest, yet the impacts on working capital and cash flow happen instantly requiring revision of the regulatory protections as early as practically possible. Therefore, we wholeheartedly support the approach of an initial assessment followed by later "true up(s)".

Ofwat needs to ensure the accounting data to estimate the initial revision to regulatory protections covers all Covid related bad debt provisions/write-offs including those that may have been booked within the 2019/20 accounts (see our responses to questions 1 and9).

Accounting standards vary - not only across different frameworks (IFRS vs FRS102 "UK GAAP"), but also within the same standard there is potential for wide ranges of interpretation and judgement. Ofwat should be mindful, therefore, that different sets of audited financial statements will include differing levels of bad debt provisioning prudence. Additionally, accounting data does not necessarily have disaggregated detail of customers in small, medium and large consumption bands, or between default and non-default tariff customer types, so these splits are unlikely to have been audited.

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 agree with the Ofwat 'minded to' position of an April 2022 (rather than October 2021) implementation of any regulatory protections discussed to date, all of which require the creation of new sets of default tariffs.

Whilst we recognise the potential cash flow benefit of bringing the implementation forward to a mid-year point, there are a number of disadvantages of doing so (bulleted below), which in our opinion will outweigh the potential positive impact of an October implementation. Increasing customer bills in October 2021 will:

- be highly unpalatable to customers, as regardless of the size of increase, they will be faced with higher bills at a time when they did not expect changes (unprecedented time of the year) and when cash reserves are likely to be heavily depleted as Covid trading restrictions would have only recently been lifted - or may even still be in place;
- create confusion for customers, who would not have budgeted for the increases and may assume the new bills are erroneous;
- increase customer call volumes and complaints, given the confusion and dissatisfaction set out in previous bullets;
- perversely have the potential to adversely impact in-year cash flow if: i) the mid-year tariff changes require billing system logic changes that are long lead-time activities, causing a delay in the new bills being despatched; and/or ii) the customer concerns flagged in the earlier bullets lead to long lead-time satisfactory customer query resolution before payment is made; and
- require Retailers to incur additional costs to best mitigate the downside impacts of the above bullets, which will offset some/all of the planed cashflow benefit.

Whilst the urgency of relief for Retailers must remain a priority, any financial benefit of an early (October 2021) implementation must outweigh the additional cost of delivery and concern to customers. **It is our view that an April 2022 implementation represents the better approach**.

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?

In terms of best alignment to the specific defined **'objectives' set out by Ofwat**, the amendment of REC price caps represents the simplest approach.

As we have stated in previous responses, however, the use of REC price caps to recover additional bad debt costs only provides **opportunity** for Retailers to recover excess bad debt. Dependent on how the competitive market reacts to price increases, the opportunity, however, could ultimately outturn in significant under/over recovery of the excess bad debt relief by individual Retailers.

We recognise the need for any mechanism to ensure that it does not create potential perverse incentives for Retailers to reduce efforts in chasing bad debt. However, the current proposal represents an overabundance of caution to this regard. In particular, the currently proposed aggregation of data at the market level will ensure that geographic variances experienced in response to the pandemic (such as local lockdowns) are not accounted for. As currently stated, the proposals look set to create market 'winners and losers' based on factors outside of their control, not solely on the basis of their own debt management performance. Any potential distortion could reasonably be deemed 'unfair' by market participants, and such an approach may therefore be open to further challenge should individual stakeholders be particularly disadvantaged.

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

With regards to Option 1 (REC Approach), we agree that this represents a "straightforward and clear" process that would be relatively low cost to deliver (both to the market and individual participants). That said, as currently drafted, by using an industry average approach, we do not agree that this proposal represents a cost efficient methodology to tackle the risk of systemic Retailer failure as it does not sufficiently address the variability between customer groups e.g. enforced geographical lock-down differences.

With regards to Option 2 (Wholesale Charge Approach), we agree that this option provides the most certainty for Retailers and therefore best protects customer's long term interests. We also agree that this would represent a more complex implementation for parties, although we believe that this complexity could be deemed justifiable dependent on the potential outcomes. Whilst we recognise the argument that there may be some element of 'incentive dilution' regarding handling bad debt, we disagree this would be prohibitive and believe other considerations and mitigations could be considered to ensure this does not occur. That said, we would reiterate the concern that increasing wholesale charges would increase working capital requirements for Retailers which will create an additional disadvantage.

We are aligned that Option 3 (Retail Levy) represents many of the same benefits and challenges as Option 2. However, critically we believe that it performs better than Option 2 on the basis that it mitigates the requirement for additional working capital to pay for increased wholesale charges. **Option 3 (Retail Levy) still remains our preferred option**.

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).

Ofwat's stated policy aims to avoid risks of systemic Retailer failure, whilst minimising additional costs for customers in the shorter term. It seeks to promote efficiency and support competition by retaining strong incentives on Retailers to manage bad debt costs.

We believe that once bad debt has reached the 2% threshold of turnover, Retailers have already incurred their fair share of additional debt that was never financed for within the regulator determined price caps to date*. Consequently, we have previously recommended that no additional bad debt costs (above the 2%) are placed on the Retailer, and Ofwat should consider alternative options, including sharing the burden with the Wholesalers.

Given that our previous response is not being applied within Ofwat's current proposal, we agree that a sharing mechanism should be implemented so that Retailers do not have opportunity to avoid chasing debt without financial consequence. However, we would recommend that the 50:50 share is removed and instead the 25% Retailer vs 75% Customer share of the excess bad debt cost should be applied once 2% bad debt has occurred.

*The default price control was established for small customers as a cost allowance (based on costs advised by wholesalers, originally for PR14, and challenged by Ofwat to a level believed to be efficient – which we understand included a bad debt level of approx. 1%) along with a small net margin (approx. 2.8%). If bad debt costs as a result of the pandemic for customers below 50Ml are [Redacted] (as per current forecasts), this would exceed the theoretical margin of a small customer and therefore leave Retailers servicing these customers on a non-sustainable basis (risk of systemic Retailer failure).

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

Given the approach set out, we would be keen to see a single uniform uplift in net margins per customer group 1, and **a separate**, single uniform uplift in gross margins per customer group 2. See our response to question 11 for further detail.

Our biggest concern with the approach, is the notion of splitting the information into pre and post January 2020 usage. Excess bad debt costs need to be determined by reference to increased levels of uncollectable debt, above the historical norm, as a result of Covid. The current minded to proposal looks to restrict the excess debt calculations to a charging period starting January 2020, but this excludes earlier charged for periods that would normally be expected to be collected, even if it took a year or more, that might not now be possible because of expected and unprecedented high instances of Covid caused business failures.

As long as an appropriate 'historical norm' of bad debt (provision and write-off) calculation is undertaken prior to March 2020, any movement between this and subsequent levels of bad debt (provision and write-off) can reasonably be attributed to Covid.

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 finance costs that need to be considered are those arising from delays to collection of debt. Aged debt will not turn bad in all instances, but measures taken to protect customers (such as not chasing payments or carrying out disconnection activities) will have increased the aged debt profile, leading to additional working capital costs for Retailers.

One way to estimate the impact of aged debt is to consider movement in debtor Days Sales Outstanding (DSO). E.g. If debtor days have increased by 10 days, the working capital can be assumed to be total annual wholesale charges / 365 *10.

The most sensible cost of capital would be the average weighted cost of capital of all Retailers in the market.

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.**

We believe there is strong merit to separating out the 0 to 0.5Ml and 0.5 to 50Ml customers segments into two separate pools, with separate uplifts for each group of customers.

In line with question 2, it is our belief that that there will be a material difference between the two customer types in terms of the level of bad debt that will be written off as a result of Covid and the associated restrictions and protections. This view appears to be supported by the data provided by the market, as evidenced by Figure 4 (in the consultation document) identifying higher rates of bad debt provision across the market. Whilst our own bad debt provisioning rates do not yet indicate such a clear distinction, we expect this to emerge once more data becomes available.

The use of a single 'average uplift' would not be appropriate given the material likelihood of variance between the profiles of the two groups, with this averaging not only creating an

effective cross-subsidy of risk but also potentially raising questions of anti-competitive pricing. We support the use of two separate pools, and would invite Ofwat to consider further areas of granularity such as excluding contracted customers, to best ensure that the appropriate levels are established and recovery opportunity is best aligned with the differing risk profiles of the separate pools.

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?

The data and information Ofwat intends to seek appears to be consistent and fair in relation to its current 'minded to' approach of adjustments to the REC price caps. We note there may yet be a different approach and will continue to monitor the suitability of the data/information as further operating mechanism details, including true up(s), of the minded to (or alternative) approach emerge.

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 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 enduring price rises for customers?

We think it reasonable that a two-year period should be assumed for now. For avoidance of doubt, however, we are not suggesting the protection mechanism will necessarily be implemented and completed within two years. Due to the remaining uncertainties around the on-going pandemic, government restrictions and critically the extent to which the economic impact of these factors will persist, we believe there is strong merit to ensuring that any recovery mechanism remains open and responsive as the situation develops and more data becomes available. As such, we believe that the two year 'starting assumption' needs to be able to adapt and be extended over further years if necessary.