Introduction

In the latest draft proposal 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 due to the proposed parameters for sharing the burden with customers and the expectation that Retailers should bear 2% each year before any cost sharing mechanism would apply. We consider the level of excess bad debt costs Retailers will be expected to bear to be unsustainable and Ofwat's proposals do not sufficiently address the risk of systemic Retailer failure.

We believe 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 risk of systemic Retailer failure.

We understand that Ofgem is reflecting additional bad debt costs in the domestic energy retail price cap and has implemented the adjustment such that Retailers can start recovery from 1 April 2021.

We have responded to the questions posed as set out below.

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?*

Wave's view is that bad debt costs are likely to exceed 2% of total non-household revenue in 2019/20 and 2020/21. It's not yet clear for 2021/22.

We have some concerns that Ofwat has not asked for likely outturn bad debt costs for 2019/20 when Ofwat has indicated on page 21 of the consultation that it is minded to take into account relevant increases in bad debt costs related to usage from 1 January 2020. In order to do this, we anticipate that a view on bad debt costs for 2019/20 will be needed. In our response to question 12, we have explained why we do not support a cut-off date which separates out bad debt based on when services were delivered or billed.

We have provided Wave's expected bad debt costs as recognised in the P&L for 2019/20, 2020/21 and 2021/22 as follows:

Year	Bad debt costs
2019/20	
2020/21	
2021/22	

These numbers represent the bad debt charge to the P&L, which comprises movements in the provision for expected future write offs and any actual write offs processed. For 2020/21 these represent a range because final figures are yet to be confirmed. For 2021/22, this is an estimate based on the assumptions we have used for our internal business planning.

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?*

The evidence shows that lower consumption customers have been affected more significantly by Covid-19 relative to larger consumption customers.

This graph shows the resolution rate of billed debt by the time it reaches 120 days/4 months old. It shows resolution of Industrial and Commercial (I&C) debt vs Small/Medium Enterprises (SME) debt. We have included the pre-Covid average for each indicating that pre-Covid, of I&C debt was resolved by 120 days and of SME debt was resolved by 120 days. The trajectory of both has dropped, but latest data from last month shows that I&C has whereas SME is This clearly demonstrates that lower consuming customers have been impacted more than higher consuming customers.

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, increases in bad debt costs over historic BAU levels are likely to continue to accrue during 2021/22 and beyond.

Whilst we expect business activity and payment of bills to return to some normality in the coming months as lockdown measures are lifted, for a subset of customers, we expect the impact of the last 12 months disruption will crystallise as financial support provided by the Government (e.g. furlough & business loans) starts to ease/unwind, resulting financial distress, non-payment and ultimately an increase in insolvencies.

Data from Experian indicates that there is a backlog in insolvencies in the UK following the suspension of strike-offs in summer 2020 by Companies House. The impact of this may not yet have been observed and therefore we might expect to see an increase in insolvencies over forthcoming months as the backlog is cleared.

Experian have noted:

- "Large numbers of new credit accounts opened as a result of CBILS and BBLS. Still more accounts being opened more than 6 months after the start of these schemes." More start-ups is usually an indicator of higher levels of fraud, and therefore a leading indicator of debt risk.
- "Large increases in total credit balance compared to beginning of 2020. Sectors that are struggling have been able to access credit, but have businesses overextended themselves?"

- "Changes in trade credit performance provides an early warning of stress. Businesses of all types are paying suppliers later. Most stretched sectors see largest slowdown in paying suppliers"
- "With many businesses' survival being prolonged by support schemes, there could be an upcoming glut of failures in short order that could overwhelm standard collections & recoveries practices"

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'?*

Yes, in principle, Wave supports using available Retailer accounting data to estimate an initial revision to regulatory protections but we are concerned how the 'true-up' may work in practice. We have covered this further in our response to question 6.

As we set out in our Call for Information, Standard accounting practice / IFRS9 already sets out an approach to measure bad debt costs, so we would advocate using the same established approach, which is already objective, consistent and verifiable. We feel strongly that Retailers' bad debt P&L charge should be used as the baseline for the mechanism which is 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.

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.*

Wave supports earlier regulatory protection taking effect from October 2021.

On the basis of these proposals, particularly the level of exposure expected to be borne by Retailers, price rises for customers are unlikely to be material (i.e. less than 5%), but starting recovery earlier does smooth bill impacts and benefit customers through greater mitigation of the threat of systematic Retailer failure as Retailers receive financial support earlier. These benefits outweigh the practical challenges of a mid-year change and therefore all stakeholders (including Ofwat) should be willing to undertake whatever work is necessary to support earlier implementation. Using a REC amendment is more straightforward to implement than alternatives and should be achievable within the October timeframe.

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?*

Wave's concerns relate to how the 'true-up' would work in practice. We would like to see this developed more fully as currently this creates the most uncertainty and risk which could impact our ability to maintain financial support from lenders.

We're not clear whether the 'true-up' is intended to be based solely on write-offs? If that were to be the case, we envisage that write-offs would take a considerable number of years to crystallise. [redacted] Given that our understanding of the draft proposals is that the 1% / 2% / 3% refers to the P&L charge which is made up of both movement in bad

debt provision and write off costs, this would also seem a more appropriate basis for consideration of any 'true-up'.

Neither are we clear how the 'true-up' would be applied in a way which does not distort competition or competitive outcomes. It seems that the 'true-up' could be implemented through a further amendment of REC price caps, either as part of a wider REC review or separately. This approach implies that the impact would be borne 100% by those Retailers with customers on default tariffs. For Retailers whose customers are on contracts, the 'true-up' wouldn't apply therefore the cost of any overestimation or improvement in market-wide performance would be entirely borne by those with customers on default tariffs.

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

See our response to question 6 above.

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).*

Retailers now appear to be expected to bear a greater proportion of excess bad debt costs than the 2% cap first anticipated. In reality, customers will fund very little of the excess exposure because Retailers will bear everything up to 2%, an additional 50% of costs where costs are 2-3% and an additional 25% where costs exceed 3%. This seems an arbitrary proportion and significantly higher than is needed to provide sufficient incentives for Retailers to chase and collect debt. We support an approach 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. We have identified Wave's current marginal costs of debt recovery as [redacted] prior to disconnection, [redacted].

We understand that Ofwat considers 2% of revenue to be an appropriate level of excess bad debt that a prudent Retailer should be prepared for in an 'anomalous year'. We support the view that it would not be appropriate to expect Retailers to bear 2% each year before any cost sharing mechanism would apply. Rather, it should only apply in the first year, with the excess being everything over 1% (or historic levels) in subsequent years.

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 have set out our views in our responses to the other questions.

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?*

We strongly support inclusion of an allowance for efficient working capital costs and recommend using changes in a Retailer's debtor days to calculate the impact.

The working capital impact on Retailers is broader than just the slippage in debtor collection, as with the reduced consumption seen during the pandemic and the way in which CMOS works (estimation routine as well as lagged re-runs), Retailers have seen a drop off in revenue

and billing much quicker than seeing a corresponding reduction in settlement charges. However, it is difficult to allocate this cost to a customer level and will ultimately reverse as the economy starts to recover.

Additionally, the working capital required during this Covid period has been harder to cover given the decreased revenues seen by Retailers, as bad debt aside, there has been less contribution towards fixed costs.

Consequently, Wave would recommend using the following approach:

- Debtor Days to be assessed each month during the pandemic:

$$\frac{\text{Unpaid debtors}}{\text{Rolling 6m reported revenue}} \times 365$$

- Comparison of Debtor Days against Pre-Covid debtor day average to give Incremental Debtor Days during the pandemic
- Multiply Incremental Debtor Days by rolling 6m reported revenue to give Incremental Working Capital
- Multiply Incremental Working Capital by the marginal borrowing cost, which should include the deferred wholesale mechanism (i.e. interest charged at 5.98%).

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.

Wave supports pooling bad debt across all customers with annual consumption less than 50Ml.

Evidence (as provided in our response to question 2) shows that lower consumption customers have been affected more significantly by Covid-19 relative to larger consumption customers, however, targeting recovery from the lower consumption customers means higher price rises for those customers who have been hardest hit. These are also the type of customers most likely not to pay so pooling helps mitigates the risk of lower collection.

We also think that a pooling approach better meets Ofwat's objectives because it negates the need for more detailed/segmented data (which Retailers may find difficult) and the associated implementation costs. It would ease the risk of error in estimating relevant excess bad debt costs for specific customer groups mitigating the potential to distort prices and competition.

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?

Overall, the data and information sought seems appropriate and achievable, with the exception of providing provisioning data for the different customer classes. We can apportion provisioning data to all customers based on bill date, but we cannot split bills (and provision) into supply period (as would be required given current proposal to look at supply from January 2020 rather than bills issued).

Principally we are not supportive of a cut-off date which separates out bad debt based on when services were delivered or billed. 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/is expected to go bad due to Covid than otherwise would have done, and this increased risk is be reflected in the higher provision held post Covid. Therefore, we support looking at bad debt P&L charges before Covid and consider that as a baseline.

Whilst not preferable, if total movement in provision is not accepted and a cut-off of older debt at 31 March has to be used, then 1 January 2020 should be the baseline for bills impacted by Covid-related bad debt. As part of the data required for revising the REC price caps, Ofwat has indicated that the provisions for bad debt and write-offs need to be split between usage relating to pre and post 1 January 2020. The trigger for debt risk is not the supply date but the issuance of a bill and whether a customer can respond to that demand for payment when it is presented. Any analysis available or requested would be based on the Wave's debt book, which is aged based on bill date, not supply date – it would not be possible to recut the debtors and provisioning by usage period. Wave therefore strongly suggests that if a cut off is necessary, the cut-off should reflect the trigger of the risk, i.e. bills issued post 1 January 2020, and not usage post 1 January 2020.

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?*

Wave supports a shorter time horizon.

On the basis of these proposals, price rises for customers are unlikely to be material and therefore spreading across multiple years does not seem necessary in order to maintain protection from bill shocks. In addition, depending on the contractual terms and conditions offered by Retailers, prices for contracted customers may be able to be adjusted without a longer time horizon. Therefore, on balance we would prefer the adjustments to be made quickly. If recovery commences in October 2021 then it would make sense for the time horizon to run for 18 months but if recovery commences in April 2022 we would prefer the time horizon to be 1 year.