May 2021

Update: Business retail market – Customer bad debt

Ofwat

1. Introduction and purpose

Ofwat in March 2021 consulted on Customer bad debt in the business retail market. We hosted a webinar on 24th March 2021 for interested parties to seek clarification on the issues we had consulted on.

Among other things, the consultation set out and sought views on our 'minded to' position that it appears likely that the market-wide 2% threshold for additional regulatory protection will be met. We also set out and sought views on our minded to position that we propose to enable retailers to recover a portion of excess bad debt costs from non-household customers via a market-wide, uniform uplift to the price caps applying under the Retail Exit Code ('REC').

We set out some options for the timing and sequencing of the recovery, and in particular sought views on whether recovery (which would be amendments to the REC price caps if and where we pursue this option) should take effect either from October 2021 or April 2022. We indicated our preference for April 2022.

Following receipt of responses to the consultation, this document sets out our decision (in the event that the 2% threshold for additional regulatory protection is met) to amend regulatory protections such that retailers are able to begin recovery of a portion of excess bad debt costs from non-household customers from April 2022. (See section 2 below).

We also include here a clarification concerning an allowance for the (efficient financing costs of) efficient working capital costs, which we have suggested may form one element of costs to be recovered by retailers. (See section 3 below). To be clear, this notice sets out our decision in relation to the March 2021 consultation question 5 only. We are still considering the evidence in relation to all other March 2021 consultation questions, including question 10.

This notice **sets out our proposed timetable going forward. This includes publishing our decision on all other consultation questions and also how we intend to consult on and amend regulatory protections applying from April 2022.** (See section 4 below).

2. Our decision regarding the timing of recovery of excess bad debt costs

What we said in the consultation

Our consultation (§5.4) set out, and sought views, that in the event that amendments to regulatory protections are warranted in the light of outturn bad debt costs, we are minded to amend REC price caps as the mechanism for enabling Retailers to recoup (a portion of) excess bad debt costs.

Our consultation (§4.3.3) also set out and sought views regarding the timing of when any amended regulatory protections should take effect from. We set out two options: Option (1) from 1 October 2021 and Option (2) from 1 April 2022.

Noting that some Retailers had set out in their responses to our November 2020 Call for inputs that earlier revision of any regulatory protections, including during 2021-22, would deliver them some cash flow advantages, we also set out that there are a number of factors to be considered in deciding between Options (1) and (2):

- accuracy of the underlying data / calculations and fairness to customers;
- audit and verification requirements; and
- ability of industry billing / accounting systems to accommodate changes.

We set out our view that Option (2) – amendments to regulatory protections taking effect from 1 April 2022 - has the benefit of basing the adjustments on audited results for the most recent reporting year, typically 31 March 2021 for the majority of retailers. It would also give us a better understanding of what is happening to bad debt levels following the expected unwinding of Government support schemes and – if and where we implement our preferred option to amend REC price caps - give retailers serving non-price controlled customers more time to anticipate and adjust their pricing response.

We also noted our plan to commence a wider review of the REC price caps later on in 2021/22, with any adjustments resulting from this expected to be implemented from April 2023. Therefore, if and where we enable recovery of (a portion of) excess bad debt costs from non-household customers by uplifting the REC price caps, then any final adjustments ('true up') could be combined with any adjustments we make as part of this wider review and implemented from April 2023.

We consulted on timing questions as follows:

March 2021 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.

Summary of responses

Three of ten retailer respondents and three of five wholesaler respondents said they favoured or indicated some preference for any recovery to take effect from October 2021. Reasons included that it was an achievable date, including because the adjustments would be based on estimated data with a later 'true up'; would benefit customers through greater mitigation of the threat of systemic Retailer failure as Retailers receive financial support earlier; and that starting recovery earlier would smooth bill impacts on customers and/or reduce the level of working capital allowance that Ofwat would, under its proposals, otherwise need to make in the uplift.

One retailer noted that, were the recovery mechanism to be implemented from October 2021, a retailer should have the option of delaying implementation until April 2022, for some or all of its customers, without suffering any financial detriment i.e. funds that could have been recovered between October and March would then be recovered from April 2022. This retailer also signalled that, if the support mechanism does not commence until 2022, it favours Ofwat's suggested approach to include the cost of financing the bad debt in the recovery mechanism.

Three of ten retailer respondents as well as CCW said they favoured or indicated some preference for implementation of any recovery mechanism from April 2022. The three retailer respondents as well as CCW suggested for example that mid-year price changes (as would be allowed where adjusted REC price caps apply from October 2021) could be problematic or administratively burdensome or costly, for retailers and/or customers. One retailer qualified its view here with the provision that the quantum of recovery stays the same (i.e. in respect of an adjustment from April 2022 vis-à-vis October 2021).

CCW said that an extended recovery period should be allowed to take place before any potential increase in prices are introduced and noted that the costs of bad debt are unlikely to be apparent for some time; for both reasons, CCW set out its general support for revised regulatory protections taking effect from April 2022. CCW also noted that it is important that the recovery mechanism is applied over a number of years so the impact is spread out in order to lessen the impact on business customers, and that it would like to understand the likely impacts on customers of Ofwat's anticipated wider review of REC price caps before any regulatory protections for bad debt costs are implemented.

Ofwat view

We recognise that amended revised regulatory protections taking effect earlier rather than later would, absent other changes, have benefits of delivering earlier relief to those retailers who have particularly experienced increases in customer bad debt levels and so better help to mitigate risks of systemic retailer failure. However we think such concerns can be addressed with our 'minded to' position that retailers should be able to recoup efficient working capital costs incurred in financing (the retailer portion of) excess bad debt costs. Where revised regulatory protections took effect from April 2022, this would include efficient working capital costs incurred over the period October 2021 to April 2022, so providing an alternative for relief to begin from October 2021. Furthermore we have not seen arguments or evidence as to why such an approach would be insufficient to meet concerns about regulatory protections taking effect from October 2021 rather than April 2022.

By contrast, we note that revision from October 2021 raises the prospect of mid-year tariff revisions for customers which involve costs and administrative hurdles for both customers and retailers. We note one retailer's suggestion to have discretion concerning the date of implementation, but we have concerns that different implementation dates by different retailers would not be clear for customers.

It also raises difficulties in terms of collecting and assessing bad debt cost data from retailers for the financial year 2020/21, meaning for example that there are increased risks of errors in adjusting REC price caps, if and where this is our preferred means of revising regulatory protections.

On balance therefore we have decided to work towards amending regulatory protections (in the event that the 2% threshold for additional regulatory protection is met) to take effect from April 2022.

3. March 2021 consultation – clarification on the question of efficient working capital costs

Regarding the bad debt costs that Retailers may be able to pass through to customers via revisions to regulatory protections, our consultation (§7.3.3) said there is merit in making some allowance in respect of efficient working capital costs incurred in financing such bad debt costs during 2020/21 and 2021/22, up to the point REC price revisions take effect (i.e. either from October 2021 or April 2022).

On this basis we consulted as follows:

March 2021 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?

Some respondents to the consultation who addressed this question called for a broad approach to estimating working capital costs aimed at recognising that working capital requirements have in their view in general increased as a result of measures to combat the Covid-19 pandemic. For example one retailer noted that retailers have seen revenue and billing fall more quickly than corresponding reductions in settlement charges.

We would like to clarify, ahead of our Decision document scheduled for later in 2021, that we have in mind that efficient working capital costs should relate only to the costs of financing (the retailer portion of) excess bad debt costs from the point at which they arise to the period over which revised regulatory arrangements take effect with the aim of allowing retailers to recoup such costs. As set out above, this in the present context would mean the financing of excess bad debt costs that have arisen in 2020-21, with this recovery beginning in April 2022, when we anticipate revised regulatory protections in respect of (the retailer portion of) excess bad debt costs to take effect.

4. Timings for next steps

Our consultation noted that, following consideration of all consultation responses we plan to publish our decision later on in 2021. We also said that we will need to seek further information from retailers and plan to issue a subsequent request for information ('RFI') later on in the spring of 2021.

In the light of our decision for revised regulatory protections to take effect from April 2022, we currently anticipate the following next steps and timetable to achieve this:

Next steps	
early May 2021	Retailer RFI, for return end May 2021
July 2021	Publish Decision concerning Business retail market – Customer bad debt
October 2021	Retailer RFI, for return November 2021. To include audited or otherwise assured data for financial year 2020-21.
December 2021	Publish Consultation on parameters of recovery mechanism to apply from 1st April 2022
February 2022	Publish Decision on parameters of recovery mechanism to apply from 1st April 2022

Bearing in mind that we set out our 'minded to' position that we propose to enable recovery of a portion of excess bad debt costs from NHH customers via a market-wide, uniform uplift to the REC price caps, we also wish to note that we anticipate commencing by end 2021 our full review of REC price controls. Our intent here is that any relevant revisions in respect of the full review take effect from April 2023. We currently anticipate that we would publish a consultation on the methodology for this full review before the end of 2021, shortly followed by a request for information to retailers, for completion in early 2022.

Ofwat

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Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales.

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