business stream
A SCOTTISH WATER COMPANY

Georgina Mills
Director, Business Retail Market
Ofwat
21 Bloomsbury Street,
London WC1B 3HF

15th September 2021

Dear Georgina

COVID Customer Bad Debt: July 2021 Decision and Consultation

Please find attached Business Stream's responses to the three questions posed in the above decision and consultation paper.

As we have indicated in response to previous consultations, we welcome Ofwat's commitment to providing a COVID bad debt cost recovery mechanism, but, despite the minor movements in Ofwat's latest position, we don't believe that it goes far enough to protect customers from the risk of systemic retailer failure. Based on the data provided in Ofwat's July paper, retailers anticipate COVID bad debt for the years 2019/20 and 2020/21 to be ~£73m above the normal level, of which we will only be allowed to recover ~£19m. In a market that has been loss-making for most retailers since its inception, it is not clear how Ofwat envisages that we will meet the shortfall.

It is particularly frustrating that the treatment of retailers appears to be at odds with the regulatory treatment of wholesalers. For the most part retailers have provided extensive support to their customers during the COVID pandemic, ceasing debt recovery activities, and providing payment deferral and extended recovery plans to those businesses worse affected. At the same time, we have continued to pay wholesale charges in full, despite customer non-payment, and as a consequence, many retailers are now in a difficult financial position. A price increase of less than 0.4%, two years after the event will do little to address the problem. By contrast, wholesalers have been allowed to increase their charges to retailers from 1st April 2021 in order to recover all of the lost revenue experienced in 2020/21 and expected in 2021/22 as a result of COVID, with no suggestion of any sharing mechanism or delayed recovery to minimise the impact on us or our customers.

The future of the NHH market feels very uncertain at the moment. As attention turns to the REC Review, it is a vital opportunity to provide greater clarity for retailers and investors. We would urge Ofwat to establish some guiding principles from the outset, in the same way as for PR24, recognising the criticality of the price control in facilitating competition, delivering improved outcomes for customers and the environment, and securing the resilience of the NHH market. Similarly, we need to be clear about the objectives to be achieved – the delivery of a fair return to efficient operators; ensuring an appropriate balance of risk and reward; and re-building investor confidence.

We look forward to engaging on the REC Review at the earliest opportunity. In the meantime, please don't hesitate to contact me if you have any queries on the COVID bad debt responses attached.

Yours sincerely

[redacted]

Rosalind Carey
Regulation and Strategy Advisor

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Business Stream Response

Question 1. We are presently minded to 'pool' (the customer proportion of) excess bad debt costs across all customers and apply a corresponding uniform uplift to REC price caps. Do you agree with our approach here?

Yes, we agree that a uniform uplift across all customer groups is preferable to a two or three pool recovery mechanism.

As we indicated in response to the March/April consultation:

- given that the proportion of bad debt is higher amongst the SME customer base, we question whether those customers who have been worse hit should face a higher proportion of the cost of COVID than those who have been least impacted. We would rather the cost of COVID is recovered more fairly across all sectors of the business community; and
- in seeking to define 'pools' of bad debt associated with specific groups of customers, there is a risk of error, as well as an additional cost burden on retailers, neither of which would be justified by any upside advantage to customers.

Question 2. Do you see merit in the idea of not pursuing a 'true up'?

We agree that the administrative burden of the true-up approach proposed by Ofwat in Section 6.3 is likely to be disproportionate to the benefit of a true-up process.

However, we are aware that the different accounting policies adopted by retailers may distort the calculation of the market average bad debt, if it is based only on RFI data. Some retailers, quite legitimately, have in the past chosen not to make bad debt provisions, but wait instead to write-off debt only once collection options have been exhausted – which may be a number of years down the line. If these retailers have continued to take this approach in relation to COVID debt provisioning in their May RFI submissions[1], it would mean that the 'market average' calculation would underestimate the true impact of COVID.

Depending on the extent to which this approach to bad debt has been taken and which particular retailers have taken it, the distortion to the market average could be significant and would potentially justify a true-up. However, without knowing this, and recognising how complex a true-up may be, we suggest that, as an alternative, the final market average could be calculated by reference to bad debt provisions in retailers audited accounts, submitted in December. Our experience this year has been that the auditors have been particularly rigorous in their scrutiny of bad debt provisioning. Our expectation is that any retailers who

[1] Ofwat suggested that one or more retailer had included zero bad debt provisioning in their May RFI.

had not made COVID bad debt provisions in their 2020/21 accounts would be likely to come under pressure from their external auditors to reflect a more realistic position in order to ensure they were not presenting a false picture of their financial status. Hence it seems likely that if any retailers had made low/no (or indeed excessive) provision in their May RFI, their audited accounts are likely to reflect a more realistic position.

The use of audited information also has the benefit of being more transparent than RFI data.

Audited accounts for year ending March 2021 must be filed with Companies House by the end of December 2021 at the latest, so it would capture the majority of retailers. The market average could be calculated at the start of January, allowing sufficient time for retailers to build the uplift into their April 2022 tariffs.

Question 3. Do you agree with our approach to the 'true up' in the event we pursue one? Please explain your views.

We recognise that a true-up approach would need to ensure that retailers are only able to recover bad debt costs arising as a result of COVID, and that a bottom-up approach, as proposed by Ofwat (section 6.3), is likely to be a complex and potentially costly exercise. As set out above, we believe there is an alternative, more proportionate approach, using retailers' audited accounts, which avoids the complexity of Ofwat's proposal, but would be more accurate and transparent than using RFI data to calculate the market average bad debt, and which we would hope also addresses the risk that the calculation is distorted by retailers' diverse accounting policies.