July 2021

Business retail market: Customer bad debt – Decision and consultation

Ofwat

Executive summary

Measures introduced since March 2020 to contain the Covid-19 pandemic have significantly affected many parts of the UK economy. In the business retail market these measures could increase the likelihood of business customers defaulting on payment of water services bills. Furthermore, Retailers' abilities to respond to increased bad debt costs in these circumstances are expected to be constrained by the following:

- Our measures to protect business customers during the pandemic included temporary restrictions on Retailers' ability to pursue debt and enforcement activity in the event that customers delay payment of water services bills; and
- Retailers are constrained in their ability to amend prices for some customers because maximum price caps apply to small and medium business customers who have not engaged in the market.

Taken together this could increase risks of systemic Retailer failure, which would not be in the longer term in interests of customers. As a result, in April 2020 we committed to provide additional regulatory protections if market-wide bad debt exceeds 2% of Non-Household (NHH) turnover. This was on the basis that historical data suggested 2% represented a normal recession type scenario that a prudent Retailer was expected to have planned for.

Following multiple Retailer Requests for Information (RFIs), a Call for Inputs (CFI) in November 2020 and a consultation in March 2021, this document sets out our decisions and next steps, and seeks views on the topics of 'pooling' and 'true up'. To provide additional clarity for stakeholders, in May 2021 we published our decision that, in the event additional regulatory protections are warranted, these would be implemented from April 2022.

Decisions

D1. Whether the market-wide 2% threshold is likely to have been exceeded and therefore whether additional regulatory protections are required:

Information provided by Retailers in response to the May 2021 RFI indicates outturn bad debt costs for 2019-20 at an industry level were around 2.9%, and for 2020-21 around 2.1%, giving a cost for the 2 years ended March 2021 of 2.5%. On this basis, we have decided revisions to regulatory protections are warranted.

Reflecting ongoing uncertainties - surrounding the effect of the unwinding of lockdown and Government support measures on business customers' continued ability to pay or pay on time - we will continue to monitor bad debt costs. We will assess the bad debt cost position, both on a backward and forward looking basis, as part of our wider review of the Retail Exit Code (REC) price caps, which we plan to commence later on in 2021.

D2. The mechanism we will use to provide additional regulatory protections where they are warranted;

We have decided that additional regulatory protections should take the form of an adjustment to the REC price caps. Adjustment of the REC price caps provides Retailers with additional flexibility to price upwards in response to elevated bad debt levels, and so protect customers' interests in the longer term by mitigating risks of systemic Retailer failure. At the same time the approach preserves incentives on Retailers to manage their bad debt costs, with those who manage these costs most effectively likely to reap a competitive advantage, in line with normal commercial practice. This in turn helps protect customers' interests in the shorter term. This option also helps promote efficiency and minimise implementation costs since it can be implemented relatively easily and quickly through amendments to an existing regulatory mechanism.

D3. Once the market-wide 2% threshold is exceeded, the proportion of bad costs that Retailers and NHH customers will each bear;

Consistent with our decision in April 2020, we maintain our view that 'excess' bad debt costs should be shared between Retailers and NHH customers. Consistent with current market arrangements, Retailers are responsible for, and best placed to manage, bad debt so it is not appropriate to look to Wholesalers to share bad debt costs arising as a result of NHH customers.

We have decided that – on a market wide basis – Retailers should bear 25% of bad debt costs for the part of bad debt costs in excess of 2%, and that NHH customers should bear the remaining 75%. This will mean we will apply a 75:25 sharing factor to relevant excess bad debt costs in determining the adjustment to REC price caps to take effect from April 2022. This represents a change to our consultation proposal and is more favourable to Retailers. We consider this approach is simpler and avoids possible 'threshold' effects that may have arisen under our previous tiered approach, while remaining proportionate. Furthermore it maintains strong incentives on Retailers to manage bad debt.

D4. How the adjustment to price caps is expected to work;

To facilitate an initial adjustment to the REC price caps from April 2022, accounting estimates and provisions made by Retailers in their financial statements during the years ended 31 March 2020 and 2021 will be used. We will issue a further RFI to Retailers in October 2021 to include latest customer collections and collect updated data which should by then be either consistent with the audited financial statements or based on management's best estimate thereof.

We have decided that any adjustments to the REC price caps should apply for a minimum of two years. This will attenuate the step change in prices that customers might experience. It will also enable Retailers better to anticipate and respond to such increases on a competitive basis, which will support our objective to promote efficiency, including that any approach or mechanism should not distort competition or competitive outcomes.

We have decided that efficient working capital costs should be included within the regulatory support and relate only to the costs of financing excess bad debt costs from the point at which they arise through to the period in which they are recovered (with the calculation taking into account the effective amounts owed by customers). We would look to estimate a single efficient financing cost across the market.

If we are to pursue a 'true up' we will need a more prescriptive and quality assured process to ensure that bad debt costs measured by Retailers are consistently measured and represent a reasonable estimate of the bad debts arising due to the implementation of Covid-19 measures. Reflecting stakeholder responses and to acknowledge as appropriate the possible impact of the pandemic on existing debt, we consider it reasonable to measure bad debt costs that have arisen in respect of usage since October 2019, rather than January 2020 as indicated in our March 2021 consultation.

Further consultation questions

Based on stakeholder responses to the consultation and more up to date information in response to the May 2021 RFI, there are three areas where we have not reached definitive conclusions and are seeking further evidence and views from stakeholders via three consultation questions:

C1. Pooling – we are presently minded to pool excess bad debt costs across all customers and apply a corresponding uniform uplift to REC prices.

We have not reached a definitive decision concerning whether excess customer bad debt costs arising for all customers (ie. customer groups one, two and three) should be 'pooled'. We are currently minded to consider pooling all customer bad debt costs, principally on the grounds that some form of 'pooling' would utilise more reliable and verifiable data compared to segmenting bad debt data by customer group, and so would be the more proportional approach. Our thinking here represents a development from that set out in the March 2021 consultation and reflects mixed stakeholder responses on this issue.

C2. True up – we are exploring the possibility of not pursuing a true up – for example if estimated bad debt costs are not materially higher than the market-wide 2% threshold.

Subject to stakeholder responses we are presently minded to remain open to the idea of not undertaking a formal 'true up' process if outturn levels of bad debt across the market are not materially greater than the 2% threshold. Instead we would take into account a revised view on the level of bad debt costs Retailers are facing as part of our wider review of the REC. We would take a final view on whether or not to pursue a 'true up' after analysis of updated Retailer data on bad debt costs, which we would seek via an RFI in October 2021.

C3. True up approach – We have set out our intended approach to undertaking a 'true up', should we decide to pursue this.

Subject to stakeholder views, we have set out our proposed method for undertaking a 'true up', including the method for measuring bad debt costs incurred on usage over the period October 2019 to March 2021. As well as setting out the methodology to be applied when calculating the excess bad debt costs we would also require Retailer confirmation that the costs have been reflected in their accounting records.

Next steps

This document sets out the steps we plan to take to calculate and implement adjustments to the REC price caps to be implemented from April 2022.

Following responses to the three consultation questions included in this document and further data from Retailers in response to the October 2021 RFI, we plan to consult by December 2021 on proposed adjustments to the REC price caps to take effect from April 2022.

Contents

1. Introduction 6

2. Customer bad debt costs: the 2% threshold 10

3. Mechanism to recover costs from customers 20

4. Sharing parameters 26

5. Adjusting REC price caps and question of true-up 29

6. Implementing our decisions 43

7. Next steps 50

Annex 1 – Measurement of customer bad debt costs for purposes of ‘true up’ 53

Annex 2 – Consultation questions 58

1. Introduction

Measures introduced since March 2020 aimed at containing the Covid-19 pandemic have significantly affected the UK economy as well as customers and undertakings operating in the business retail market. Government support schemes, such as loan and furlough schemes, have sought to mitigate the effects of the pandemic and protect citizens and the wider economy from adverse effects.

We recognised that the pandemic and measures to combat it could increase the likelihood of business customers delaying or defaulting on payment of water services bills. In particular, it is possible that Retailers may face levels of bad debt beyond which an efficient and prudent Retailer could have been expected to plan for. This could in turn increase risks of systemic Retailer failure, which would not be in the longer-term interests of customers.

Furthermore, Retailers' abilities to respond to increased bad debt costs have been constrained. Firstly, our measures to protect business customers during the pandemic included temporary restrictions on Retailers' ability to pursue debt and enforcement activity if customers delayed payment of bills. Secondly, Retailers are constrained in their ability to amend prices for some customers because maximum price caps apply to small and medium business customers who have not engaged in the market.

Accordingly in April 2020 we decided that:

- Retailers should be expected to bear bad debt costs up to at least 2% of turnover;
- If a Retailer's bad debt costs already exceed 2%, it should be expecting to bear an additional 1% in full before benefitting from additional regulatory protections;
- If market-wide bad debt costs exceed 2%, we would provide protection for a portion of 'excess' bad debt costs; and
- Retailers and business customers would share the burden of 'excess' bad debt costs.

Our April 2020 decision did not specify the form of the protection or other details. Hence in November 2020, we issued a Call for Inputs (CFI) to gather further views on:

- how the 2% threshold should be assessed;
- the portion of excess bad debt costs that Retailers should shoulder; and
- mechanisms to allow Retailers to recoup a relevant portion of excess bad debt costs.

Following consideration of responses to the November CFI, as well as data provided by Retailers in response to an Ofwat Request for Information (RFI), in March 2021 we confirmed the objectives by which the customer bad debt issue would be considered, as follows:

Box 1: Policy objectives

1. **Protect customers' interests**

   We want to protect business customers, including from the risk of systemic Retailer failure.

2. **Promote efficiency**

   Any approach should minimise perverse incentives, unforeseen consequences, and any distortions to competition – including by ensuring transparency. For example it should maintain incentives on Retailers to minimise bad debt costs arising now and in future. Any approach or mechanism should not distort competition or competitive outcomes. Any approach or mechanism should be capable of being audited or checked, to ensure that Retailers submit accurate and verifiable data.

3. **Provide clarity and minimise implementation costs**

   Any approach or mechanism for reimbursing monies to Retailers should be clear and as simple as possible. It should also seek to minimise implementation costs.

Our March 2021 consultation also set out and invited views on our 'minded to' positions concerning the consideration and treatment of the customer bad debt issue as follows:

- 2% threshold: it appeared likely that the market-wide 2% threshold will be met, and that accordingly we were minded to conclude that amendments to regulatory protections would be warranted.
- Initial estimation of bad debt costs: Retailers' accounting estimates should be used to estimate initial bad debt costs. A subsequent 'true up' will then be required once more accurate information is available. We said that if the true up shows bad debt costs did not exceed the 2% threshold, we will unwind any additional protections implemented.
- Mechanism for bad debt cost recovery: Where additional regulatory protection is warranted this should be via a market-wide, uniform uplift to the Retail Exit Code ('REC') price caps. Any upward adjustments to the price caps would be in place for a minimum of, and so spread over, two years.
- Sharing parameters: If market-wide bad debt costs are equal to or less than 3%, Retailers and business customers would each be expected to bear 50% of excess bad debt costs. If market-wide bad debt costs exceed 3%, Retailers would be expected to bear 25% of excess bad debt costs and business customers 75%, in respect of all excess bad debt costs above the 2% threshold.

In May 2021 we published:

- our decision that, where any revised regulatory protections are warranted, these would take effect from April 2022;

- a clarification 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; and
- our intention to commence a wider review of REC price caps by the end of 2021, with any relevant revisions to REC price caps taking effect from April 2023.

We received 18 responses to our March consultation: ten from Retailers and one from a body representing Retailers (UK Water Retailer Council - UKWRC), five from Wholesalers, one from a NAV, and one from CCW, the consumer body for water.

This document sets out our decisions concerning the 2% threshold, the form of regulatory protection, and the sharing parameters. It also sets out further consultation questions which seek views concerning 'pooling', and the question of the 'true up' and approach to 'true up'.

The remainder of this document is structured as follows:

- Chapter 2 – sets out our decision that the 2% threshold is likely to have been exceeded and that therefore revisions to regulatory protections are at this stage warranted;
- Chapter 3 – sets out our decision to adjust REC price caps in order to give Retailers additional pricing freedom with a view to recouping (a portion of) excess market-wide bad debt costs. In line with our May 2021 update document, it follows that adjusted REC price would take effect from April 2022;
- Chapter 4 – sets out our decision that Retailers should expect to bear 25% of excess bad debt costs (i.e. those accruing above the 2% threshold), with customers expected to bear the remaining 75%;
- Chapter 5 – sets out and seeks views on our proposed approach to adjusting REC price caps, with the adjustment to take effect from April 2022. It sets out our revised view to 'pool' excess bad debt costs and sets out **Consultation Question 1** seeking views on this point. It further notes that a 'true up' may not be necessary and sets out **Consultation Question 2** seeking views on this point;
- Chapter 6 – brings together chapters 1-5 to set out how we plan to implement adjustments to the REC price caps to apply from April 2022. It also sets out - should we choose to implement it - our proposed process and method for pursuing a 'true-up'. It sets out **Consultation Question 3** seeking views on our approach to the 'true up'.
- Chapter 7 sets out our next steps.

Responding to consultation questions 1, 2 and 3

This document sets out three consultation questions which seek views concerning 'pooling' and the question of a 'true up', in chapters 5 and 6. We seek views and evidence from all interested stakeholders. Chapter 7 on next steps sets out further details of how to respond and provide views concerning these questions. In summary we welcome views on the issues relevant to consultation questions 1 to 3 by 5pm Wednesday 15th September 2021. Please submit email responses to covidbusinessretailmarket@ofwat.gov.uk, with the subject 'Customer Bad Debt July 2021 Decision and Consultation'.

Terminology

Within this document, Wholesalers are the companies responsible for owning and maintaining the physical assets associated with supplying water and wastewater services to customers. Retailers are those responsible for billing non-household (NHH) customers for their consumption, and for providing other customer-related services. NHH customers are businesses, charities and public sector organisations that are using and paying for water and wastewater services and who are eligible under industry rules to choose their Retailer. We use the term NHH customer and business customer interchangeably. The term 'Trading Parties' is used to refer to Wholesalers and Retailers collectively in this document.

2. Customer bad debt costs: the 2% threshold

2.1 Introduction

In April 2020 we confirmed that where outturn customer bad debt costs exceed 2% of NHH revenue on an industry-wide basis we will provide additional regulatory protections.

This chapter reviews the most recent data and information provided by Retailers in response to our May 2021 RFI[1] and responses to the March 2021 consultation. In particular it reviews data concerning outturn bad debt costs for the period up to March 2021, **which indicate that outturn bad debt costs for 2019-20 at an industry level were around 2.9%, and for 2020-21 around 2.1%. Across the two year period bad debt costs were 2.5% of the corresponding revenue and on this basis have decided that revisions to regulatory protections are warranted**.

In reaching our view we have relied on Retailer data and Retailers' own judgements concerning the level of provisions and write-offs that underpin their reported bad debt costs. In our March 2021 consultation we indicated that where we amend regulatory protections, it is our intention at a later stage to undertake a 'true up' in light of more accurate data. We are reconsidering whether a 'true up' exercise may be warranted or proportionate. We return to this point in chapter 5.

The remainder of this chapter is set out as follows:

Section 2.2	Recalls our March consultation questions regarding bad debt costs and the question of whether the 2% threshold is exceeded, and the possible duration of effects. It summarises responses received;
Section 2.3	Consideration of reported data and indicators of bad debt - Summarises data and information reported by Retailers in response to our May 2021 RFI concerning bad debt indicators and outturn bad debt costs; and
Section 2.4	Sets out our decision.

2.2 Consultation questions and response summaries concerning bad debt costs and the 2% threshold

2.2.1 Question of whether 2% threshold exceeded

What we said in the consultation

[1] Our May 2021 RFI sought updated data and information from Retailers, following our November 2020 RFI

We set out our view that the 2% threshold is likely to have been exceeded on the basis that Retailers forecast bad debt costs would be 2.5% of industry revenue for the year ending March 2021. Our minded to position at the time of the consultation was that amendments to regulatory protections will be warranted.

The November 2020 RFI returns indicated that the credit position had worsened through the first lockdown with increases in both the Days Sales Outstanding (DSO) and the number of credit accounts in arrears. However, as conditions eased through summer 2020 many of these indicators improved. Yet the impact of the subsequent lockdowns through early 2021 could not be fully anticipated and there was considerable uncertainty as to the outcome.

The consultation was clear that our conclusions were interim and subject to further testing in the light of subsequent information and experience. We set out our intention at a later stage to undertake a 'true up' in light of more settled decisions and experience concerning timing and the method of measuring bad debt, i.e. once more accurate information is available regarding the actual level of bad debt that companies have incurred. We emphasised that should the true up indicate that outturn bad debt costs were not above the 2% threshold we will unwind additional regulatory protections as appropriate.

Drawing further on the November 2020 RFI returns, our March consultation set out some indications of how bad debt costs may vary between different customer consumption groups, with bad debt costs segmented into the following customer groups relating to annual consumption: less than 0.5 Ml; 0.5 to 50 Ml; and more than 50 Ml. We made some provisional estimates of the effects per customer group, suggesting that provisions for bad debt costs, as a proportion of respective revenue, had been higher for lower consumption groups.

Consultation response summary

March Consultation Question 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?

Most Retailers plus a NAV took the view that the 2% threshold would or is likely to be exceeded for the year ending 31 March 2021, with several suggesting this would also be the case for 2021-22. Two Retailers as well as CCW set out their views that the impact may last over an extended period of time citing lags of up to several years in establishing true levels of bad debt and/or the full impact on businesses of Covid-19 will only be felt once the furlough scheme and other Government support finished. CCW recommended monitoring closely bad debt levels through 2021 and beyond.

Two Retailers noted the need to consider 2019-20, noting for example that they had recognised early on the possible impact of the pandemic and increased their bad debt provisions for 2019-20.

One Retailer expressed its view that if a 2% threshold was applied each year over several years this would put a serious burden on Retailers, which could lead to multiple Retailers failing.

One Retailer noted that its bad debt costs were likely to be zero for both 2020-21 and 2021-22.

March Consultation Question 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?

Most Retailers and one Wholesaler agreed that the recoverability of amounts owed by lower consumption customers and SMEs[2] has in general been most impacted by the pandemic. Views included for example that smaller businesses have seen the most disruption due to temporary closures and working from home requirements whereas, generally, larger businesses have remained open and working more normally.

Some Retailers suggested that variations in bad debt costs were more marked by industry type, for example noting that the retail and hospitality sectors had seen the biggest impact of the pandemic with the longest periods of closure leading to delayed payments regardless of customer size. One Retailer for example noted that leisure, retail, pubs and restaurants accounted for over half its provisions.

CCW noted that it is highly likely that many businesses historically using less than 0.5Ml a year have been required to close under Government guidance due to the nature of their business, and as such may have suffered financially. CCW commented that it is therefore important that measures taken to alleviate bad debt do not exacerbate the financial impact on lower income/consumption customers and stressed the need to collect more recent data to ensure decisions are based on the latest debt position.

2.2.2 Question of duration of the pandemic's effects on bad debt costs

What we said in the consultation

Recalling Covid-19 measures were first introduced in March 2020, we noted elevated levels of bad debt have so far manifested principally during the financial year 2020-21. We recognise that Covid-19 measures may have increased the incidence of delayed or defaulted payment for some usage prior to March 2020 and that a number of Retailers increased their bad debt provisions in the light of the anticipated economic issues. For this reason, we said we were minded to take into account relevant increases in bad debt costs related to usage from 1 January 2020 but would look to exclude bad debt costs arising from sales or services provided before January 2020.

[2] Responses did not always set out a precise definition of the term 'SME' in terms of the size of consumption or number of employees.

We also noted that uncertainties (for example regarding the unwinding of Covid-19 measures and the nature of the economic recovery) make it difficult to define the period during which elevated bad debts costs may arise. We set out that we consider it likely that the impact of the pandemic will continue to be seen and have an impact on Retailers through the year ending 31 March 2022 and possibly beyond.

Consultation response summary

March Consultation Question 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?

There was a broad consensus among the responses that the impact of the pandemic will continue into 2021-22, and possibly beyond. Respondents commented that businesses have been given short term relief as a result of the financial support provided by the Government. However, once this support is removed, the true financial consequences in terms of the number of businesses that are no longer viable and the resulting impacts on whether this will potentially lead to a second wave of non-payment and ultimately higher bad debt costs will take time to be understood. In view of this uncertainty, there was a view it is too early to set an 'end date', and the process should remain open and flexible to be able to react to any significant future change.

One Retailer commented on the question of when measurement of bad debt costs should start and in particular commented that Ofwat's suggestion that bad debt costs associated with services provided prior to January 2020 should be excluded would not be in line with accepted accounting practices. It went on to comment that the exclusion of bad debt which relates to services delivered prior to January 2020 could significantly reduce the proportion of excess Covid-19 related bad debt that Retailers are able to recover. The Retailer explained for example that a significant proportion of aged debt in March 2020 that turned bad as a consequence of the pandemic will have related to services that were delivered between March 2019 and March 2020.

Several Retailers noted concerns about Ofwat's intention to apply the 2% threshold per year[3]. One Retailer noted that if a 2% threshold was applied over several years this would put a serious burden on Retailers, which could lead to multiple Retailers failing, and noted that this would also not be reflective of a fully functioning competitive market, where if costs increased over a number of years, this would result in price increases. Another Retailer set out its view that initially Ofwat set an expectation that Retailers would have to absorb an additional 1% above their normal bad debt levels, but that excess bad debt beyond that would be recoverable through a support mechanism; it noted that it now understands that if the scheme extends to more than one year, which seems inevitable, Ofwat expects Retailers to

[3] Note several respondents raised this 2% per year point in response to one or more March consultation questions 1, 3, 4, 6, and 8. We reprise here views expressed in response to those questions concerning the 2% per year point.

absorb an additional 1% each year. This Retailer suggested that it is not viable for Retailers to continue to absorb an extra 1% of bad debt for a further year or more.

2.3 Consideration of reported data and indicators of bad debt

Retailers – in response to our May 2021 RFI – provided updated data to March 2021 concerning revenue levels and indicators of outturn bad debt costs, including segmentation by REC defined customer group, and aged debtor analysis and payment data. In response to the May 2021 RFI, we received responses from 15 Retailers, accounting for in excess of 95% of customers and market revenue.

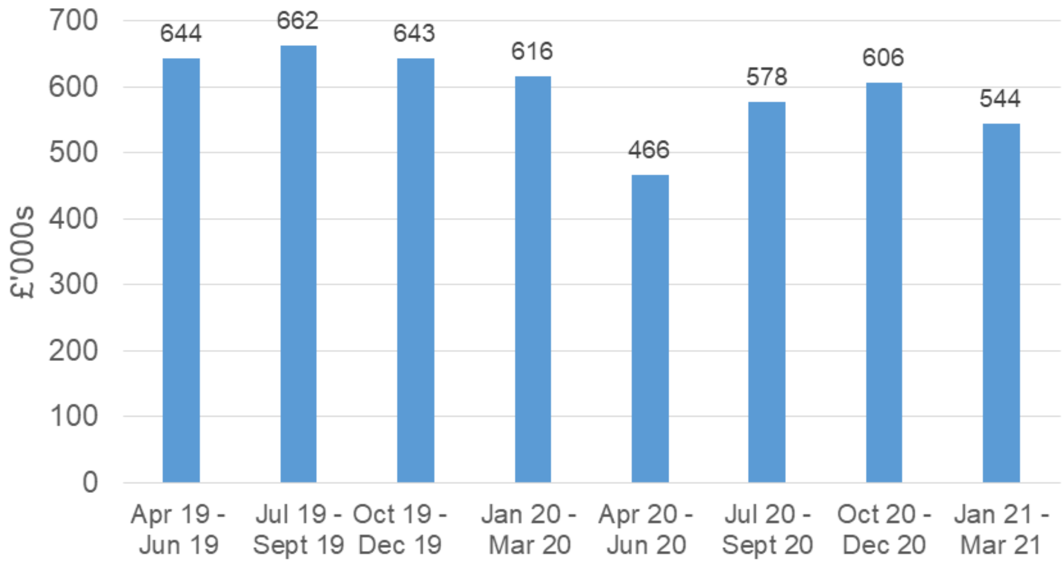
Each Retailer's data set is based on its initial management information to March 2021 and so had not necessarily been subject to external audit and/or quality assurance processes. We intend to issue a further RFI in October 2021 to gather information to September 2021 as well as updated data for the year ended 31 March 2021 which should by then be either consistent with the audited financial statements or based on management's best estimate thereof.

The following sections summarise Retailer reported data concerning indicators of bad debt and outturn bad debt costs.

Initial overview and indicators of bad debt costs

Updated data indicate both that, at an industry level, business activity is slowly returning to pre-pandemic levels, but also that the lockdown measures in place from late 2020 affected customer activity and payment. We note for example that outturn revenue figures for the last two quarters of 2020-21 (December 2020 and March 2021) are higher as a proportion of corresponding pre-pandemic levels than the first two quarters (June 2020 and September 2020). Figure 1 illustrates.

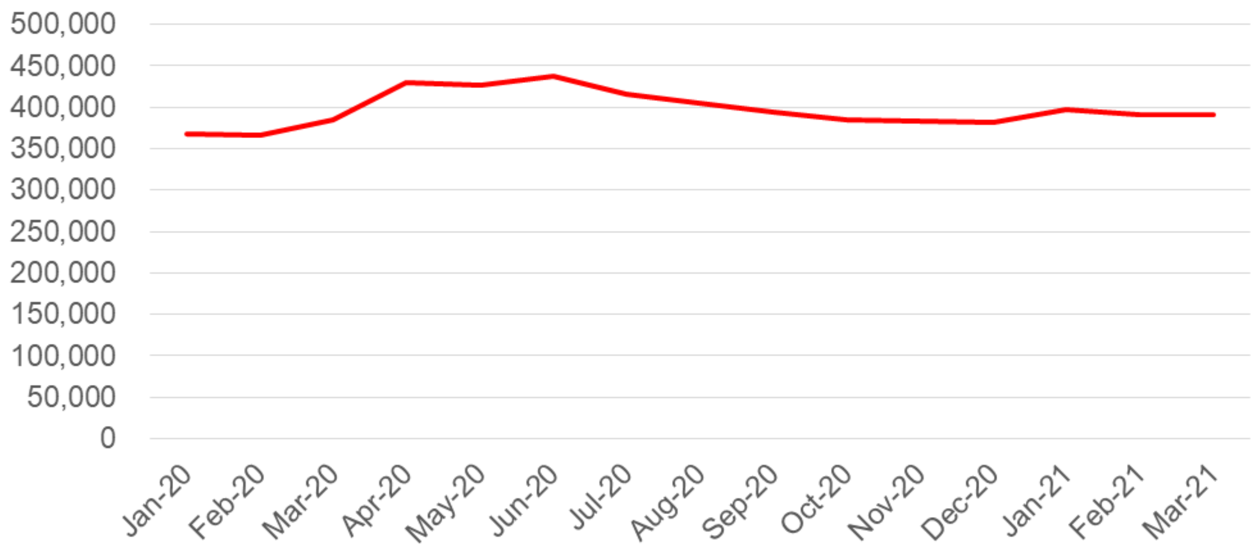
Figure 1 – Updated quarterly revenue across business retail market



Source: Retailer returns May 2021 RFI

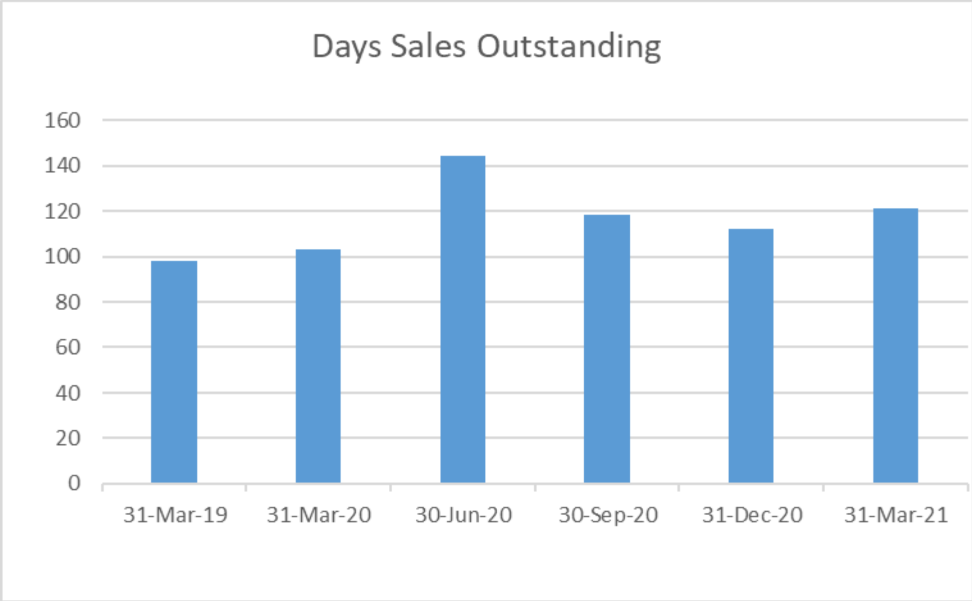
It is also clear that the lockdown measures applying later in the financial year 2020-21 have had an impact. To illustrate, the number of customers or billing accounts in arrears shifted downwards during summer 2020 but slightly upwards after December 2020, coincident with tighter lockdown measures applying from autumn 2020 onwards. Figure 2 illustrates. Similarly, Day Sales Outstanding (DSO) increased after December 2020, back to levels seen at September 2020, and higher than those prevailing before the pandemic; Figure 3 illustrates the data.

Figure 2 - Number of customer or billings accounts in arrears



Source: Retailer returns May 2021 RFI

Figure 3 - Day sales outstanding



Source: Retailer returns May 2021 RFI

Market wide bad debt costs

In response to the May 2021 RFI, Retailers reported a range of bad debt costs for 2020-21 of 0% to 13.7% of revenue. The weighted average across all Retailers – i.e. indicating bad debt costs across the market – for 2020-21 was 2.1%.

Furthermore, some Retailers have also emphasised in their responses to the March consultation that they made significant provisions for bad debt costs in the final quarter of 2019-20 in response to their perception that Covid-19 measures would increase the incidence of delayed or defaults on payments. We note that on an industry wide basis, i.e. including those Retailers who made particular provisions in 2019-20 in respect of the anticipated effects of the pandemic, bad debt costs were 2.9% of revenue in 2019-20.

Overall, at an industry level, May 2021 reported outturn bad debt costs for 2020-21 have fallen to ≈2.1% of revenue for the period. This 2.1% is both lower compared to 2019-20 (≈2.9%) and as reported in response to our November 2020 RFI (forecast for 2020-21 ≈2.5%). Table 1 summarises.

In pound terms, the 2.1% reported outturn bad debt cost for 2020-21 represent ≈£47 million. This compares to ≈£74 million for 2019-20, where reported outturn bad debt costs are around 2.9% of market revenue. Taking into account both 2019-20 and 2020-21, the reported outturn bad debt costs were ≈£121 million over the two years, equivalent to around 2.5% of the corresponding revenue over those two years.

Reduced bad debt cost levels for 2020-21 (2.1% in the May 2021 RFI compared to a forecast 2.5% in the November 2020 RFI) may indicate that the sector is adjusting to Covid-19 measures and that the provisions recognised by a number of Retailers in 2019-20 are sufficient to allow for elevated levels of bad debt in the subsequent year. We note for example that while the number of customers in arrears and debtor days both increased from December 2020 following further lockdown measures introduced from autumn 2020, these indicators did not reach the levels seen early on in the pandemic.

We do not discount however – as Retailers have pointed out – that some negative effects of the pandemic on customer delayed and defaulted payments may have been less severe owing to Government support schemes also in operation over the period, and that effects may become more apparent as these schemes are unwound. We note in this regard that Retailer responses to our recent RFIs indicated that bad debt costs during the pandemic could increase to 4% of NHH revenue with some indicating levels of up to 7%. However Retailers have not yet recognised such bad debt costs and it remains unclear whether these levels will be reached.

Accordingly the bad debt cost across the two years ended 31 March 2021 of 2.5% of revenue may be more indicative of the likely sector bad debt cost due to the pandemic.

Table 1 – Retailer reported bad debt costs

Bad debt costs as a proportion of market revenue†	November 2020 RFI	May 2021 RFI
April 2020 to September 2020	3.5%	3.0%
April 2020 to December 2020	2.75%*	2.4%
April 2020 to March 2021	2.5%*	2.1%

Source: Retailer returns November 2020 and May 2021 RFI

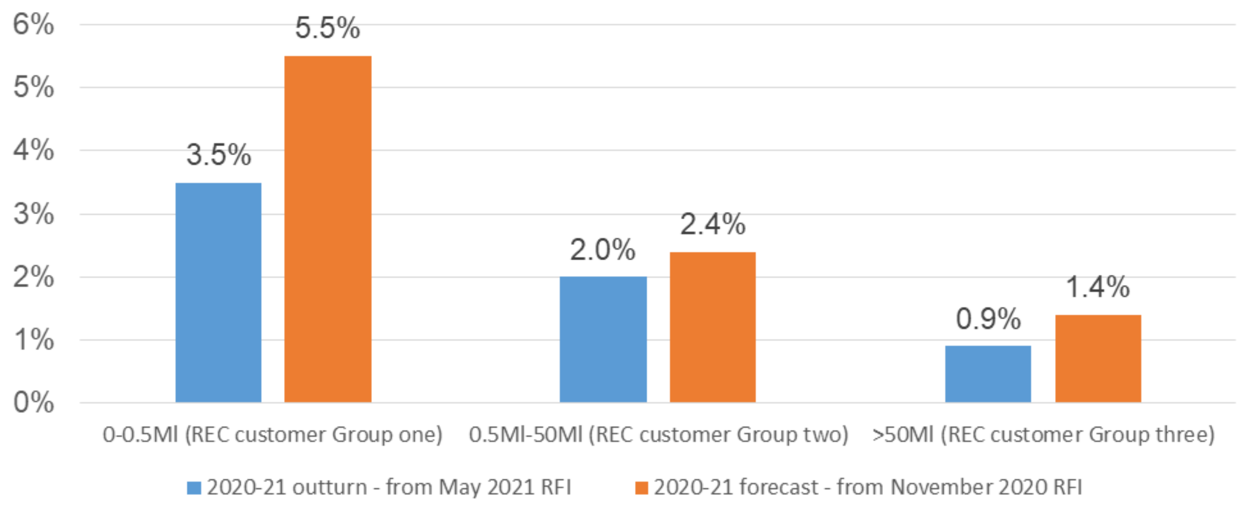
* includes forecast data

† Reported outturn bad debt costs are 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.

Outturn by consumption bands

Retailers also reported as part of the May RFI returns how bad debt costs may vary by consumption band. Retailers were not always able to fully allocate such costs to consumption bands. Some Retailers have continued to review their analysis of customer bad debt costs, and have improved their method of allocations between bandings, compared to their November RFI submissions. Revisions have narrowed the differences in bad debt costs between customer segment groups. Overall both the May 2021 and November 2020 RFI responses indicate that, across the market, bad debt costs as a proportion of relevant turnover are in general higher for lower consumption bandings. Figure 4 summarises the data.

Figure 4 – Estimated Bad debt costs by customer segment



Source: Retailer returns November 2020 and May 2021 RFI

2.4 Our Decision

On the basis of latest data reported by Retailers, we assess that across the business retail market bad debt costs as a proportion of market turnover were 2.9% in 2019/20 and 2.1% in 2020-21. Across the two years the cost is 2.5%. **We therefore conclude that the 2% threshold is reached and that revisions to regulatory protections are warranted.**

Throughout this process we have been mindful of the need to ensure that the regulatory support is made available for an appropriate timeframe that reflects the impact of the pandemic on the sector, but at the same is balanced from both the Retailer and customer perspective.

Concerning the point that the 2% threshold applies each year, we have been clear that our threshold relates to the bad debt cost levels that a prudent Retailer would have planned for in the circumstances of an economic downturn. We particularly referenced the economic circumstances of the 2007/8 financial crisis[4]. It follows that it is reasonable to expect Retailers to plan on the basis that the economic cycle effects persist for more than a year. Note we have nevertheless committed, for the purposes of the 'true up', to measuring bad debt costs against usage occurring over the period October 2019 to March 2021, therefore recognising that bad debt costs in respect of the pandemic may accommodate customer delay or default on outstanding payments which arose prior to the introduction of Covid-19 measures.

Furthermore, we note the indications that outturn bad debt costs are falling but we recognise that uncertainties remain concerning the economic outlook, and the effect of the unwinding of lockdown as well as Government support measures on the water sector and business customers' continued ability to pay or pay on time. We will continue to monitor bad debt

[4] See for example Ofwat April Decision document §4.1 p.32

costs, including through a further Retailer RFI request in October 2021. We will also assess the bad debt cost position, both on a backward and forward looking basis, as part of our wider review of REC price caps, which we will undertake during 2022.

Concerning the question of the time frame for measuring bad debt costs and the question of a pre and post January 2020 split, we return to this point in section 5.2.3.

3. Mechanism to recover costs from customers

3.1 Introduction

As we set out in section 2, we have decided that the 2% outturn bad debt threshold is exceeded and that consequently revisions to regulatory protections are warranted.

This section sets out our decision that **additional regulatory protections should take the form of an adjustment to the price caps detailed in the Retail Exit Code (REC)**. It summarises respondents' views and the reasons for our decision.

3.2 What we said in the consultation

Our March consultation set out three options for mechanisms to recover costs from customers, should the 2% threshold be reached and such cost recovery be warranted.

(1) Amend REC price caps

Recovery of (a portion of) excess bad debt costs would be via an uplift to the existing REC price caps. Excess bad debt costs would be calculated as any market-wide bad debt costs that exceed 2% and relevant sharing factors would be applied to this. Under this approach, we would apply a uniform, market-wide, uplift to the price caps. Retailers serving price controlled customers would have extra headroom to increase their tariffs. Retailers serving non-price controlled customers are already free to increase their tariffs but this will enable them to do so and remain competitive in relation to the price caps.

(2) Wholesale charge surcharge

Under this approach excess bad debt costs would be calculated for each individual Retailer. Each Retailer would recoup a portion of its individual excess bad debt costs (i.e. after the application of sharing parameters) via money collected from all customers through an uplift to wholesale charges specifically introduced for that purpose. Money could be disbursed to Retailers either through a central fund or some form of net rebate applied to wholesaler charges collected from Retailers.

(3) Retail price levy

Excess bad debt costs would be calculated for each individual Retailer in the same way as for the wholesale charge surcharge. The sum of all amounts due to Retailers (i.e. in respect of each Retailer's own (portion of) excess bad debt costs incurred) would be converted to a uniform retail price levy (i.e. £ per customer). Each Retailer would charge the levy to all their customers (irrespective of whether customers are on default prices or negotiated contract terms). To the extent that a Retailer collects levy amounts surplus to those due to it, the surplus is paid into a collective fund. A Retailer collecting insufficient levy amounts receives a 'top up' from the fund.

We set out our 'minded to' position to choose option (1) amend REC price caps as the mechanism for enabling Retailers to recoup (a portion of) excess bad debt costs. We proposed that amending REC price caps would best meet our policy objectives (see Box 1).

3.3 Consultation response summary

March Consultation Question 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?

March Consultation Question 7: Do you agree with our assessment of the options for revision of regulatory protections?

Five Retailers as well as all seven Wholesalers, the NAV who responded and CCW said they agree or do not disagree with our 'minded to' view that amendment of REC price caps is the option that best meets our stated policy objectives. Four of these Retailers, four Wholesalers and CCW also set out that they agreed with or did not oppose our assessment of the various mechanisms for recovering costs.

Reasons for agreement included views that the approach is relatively simple and/or low cost in design and execution. One Retailer also commented that adjusting the prices cap over a longer period will be better for customers and better for competition, as this will enable Retailers with contracted customers to adjust their prices in line with 'out of contract' rates. Another Retailer and one Wholesaler noted the approach incentivises Retailers to address bad debt. Although one Retailer qualified its support, arguing that the approach clearly incentivises Retailers to pursue more aggressive debt recovery strategies.

CCW also qualified its support, suggesting that there is a risk that only customers subject to price controls will bear the burden of price increases under this proposal and that while Retailers are free to increase tariffs for those not subject to price controls, there is no guarantee that this will take place. CCW requested that Ofwat explore how any price increases could be weighted across all customer groups in order to mitigate this risk.

Three Retailers said they disagreed with our 'minded to' position and that they do not agree – either fully or partially – with our assessment of the options for revision of regulatory protections. The principal reasons for disagreement were:

- 'Winners and losers'. Three Retailers and one Retailer representative body suggested that proposals would likely create market 'winners and losers', and/or fails to support all

Retailers. The creation of 'winners and losers' would be as a result of factors outside a Retailer's control, rather than solely on the basis of a Retailer's own debt management performance and would not therefore mitigate the risk of systemic Retailer failure. Two of these Retailers suggested that reasons for higher than average bad debt costs could include a Retailer's customer base, the extent to which a Retailer supported customers during the pandemic, and variations in effects of regional lockdown restrictions.

- Pricing freedom. One Retailer suggested that one advantage of the proposal stated by Ofwat may be undermined or invalid as follows:

  - Pricing freedom competed away – Retailers with lower bad debt cost may compete away additional pricing benefits that an adjusted REC retail price cap affords Retailers in higher bad debt cost positions. This could increase the risk of Retailer failure.

    Or that:

  - Pricing freedom will be ineffective – one Retailer argued that Retailers would face the risk that market average outturn levels of bad debt turn out to be lower than the initial estimate used to set the REC price cap adjustment. In this case, a true up would mean Retailers would be required to subsequently re-pay customers the over-recovery and in view of this risk, all Retailers would simply price up to the new level of the REC price cap. In addition, for some Retailers (whose levels of bad debt significantly exceed the market average) this approach would still result in significant under recovery, meaning the risk of Retailer failure is not addressed.

- Lack of fairness. Four Retailers argued that it was unfair or iniquitous that the proposed recovery mechanism is constructed around the recoupment of bad debt costs from customers on price capped tariffs, including potentially as a result of the 'true-up'. One commented that it may mean that contracted customers, i.e. those not on tariffs subject to price caps – who are often the largest and financially strongest customers - may be able to avoid making a contribution to Covid-19 bad debt costs. This Retailer also suggested that Retailers with a large proportion of contracted customers would be disadvantaged compared to those with a greater proportion of customers on tariffs subject to REC price caps. One Retailer argued that focusing bad debt recovery on adjusted REC prices which apply to customers subject to price caps, and which could be competed away, means that Ofwat will have enforced a loss making position on (incumbent) Retailers with a customer base comprised mainly of customers on price capped tariffs. UKWRC noted that 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.

- Uncertainty. One Retailer argued that the timing and extent to which a Retailer is able recover its bad debt costs is dependent on the debt levels of all other Retailers (including as a result of Retailers' different customer portfolios and accounting policies) and this creates uncertainty, which can also increase finance costs.

One Retailer suggested two variants of the REC adjustment designed to address – in its view – the drawback of a uniform REC adjustment that would not recognise each Retailer's bad debt circumstances:

(i) Uniform REC recovery and redistribution: As proposed, Retailers recover a uniform uplift from deemed customers and contracted customers where possible, but funds are then pooled and redistributed to Retailers based on demonstrated cost incurred; or

(ii) Company specific REC recovery: the REC is amended to allow each Retailer to recover their own (validated) bad debt costs, and Retailers have the competitive freedom to recover what they consider reasonable up to that level. The Retailer suggested that this is more akin to the effect of a competitive market than the current proposal, and that Retailers could choose when to commence recovery and over what period.

One Retailer highlighted that its concerns relate to how the 'true-up' would work in practice, and said it would like to see it developed more fully as it creates the most uncertainty and risk which could impact its ability to maintain financial support from lenders.

3.4 Our decision

We have decided that, where revisions to regulatory protections are warranted in the light of increased industry wide bad debt costs, **Retailers should be able to recover (a portion of) market-wide excess bad debt costs via market-wide, uniform upward adjustments to the REC price caps**. We consider that amending REC price caps will best meet our policy objectives set out in Box 1.

Our decision follows our reasoning as set out in the March 2021 consultation document. Adjustment of the REC price caps aims at giving industry additional flexibility to price upwards in response to elevated bad debt levels, and so protect customers' interests in the longer term by mitigating risks of systemic Retailer failure. At the same time the approach preserves incentives on Retailers to manage their bad debt costs, with those who manage these costs most effectively likely to reap a competitive advantage, in line with normal commercial practice. This in turn helps protect customers' interests in the shorter term.

This option also helps promote efficiency and minimise implementation costs since it can be implemented relatively easily and quickly through amendments to an existing regulatory instrument, i.e. the REC price caps. The price caps are transparent, well understood and relatively straightforward for Ofwat to implement. Furthermore, it is likely to be relatively straightforward and transparent to estimate (increased) bad debt costs and make a uniform upward adjustment to the REC price caps by reference to industry averages.

In our view, and for the reasons set out above, the approach obviates any need for - and offers relative advantages over - mechanisms finely tuned to each Retailer's individual circumstances and outturn bad debt position. That is, the creation of additional flexibility to price upwards via adjustments to the REC price caps in our view meets our objectives while avoiding the pitfalls of introducing arrangements finely tuned to each Retailer's circumstances (as envisaged for example under options (2) (wholesaler charge surcharge) and (3) (retailer levy) as set out in our March 2021 consultation).

Regarding the views put forward by respondents to the March consultation who did not favour adjustment to the REC price caps, and noting that our aim for adjusting the REC price caps is to create additional pricing freedom across the market, we comment as follows:

- 'Winners and losers'

  We recognise that a market-wide uniform adjustment to price caps will – all other things equal – create some winners and losers since some Retailers will face and manage bad debt costs better than others. This is in line with normal commercial practice and creates stronger incentives for Retailers to manage bad debt costs. Furthermore the possibility that some 'losers' may emerge does not, in and of itself, significantly increase the risk of systemic Retailer failure. We are not seeking to prevent individual Retailers from exiting the market, as some supplier exit is a feature of any functioning market.[5]

  We recognise that bad debt costs may to some extent have varied between sectors (e.g. hospitality, leisure where lockdown restrictions generally had a greater effect on businesses than for other sectors) and regions (e.g. owing to regional lockdowns). But it is not clear to us, and nor have Retailers put forward convincing evidence, that such effects systematically and materially disadvantage some Retailers over others in terms of some Retailers being less able to control their costs than others as a result of such circumstances, particularly over the course of the whole pandemic where all regions have at some point been subject to particular and temporary lockdowns.

  Concerning Retailer customer portfolios, we recognise that lower consumption customers have tended to give rise to higher (proportionate to their turnover) bad debt costs than larger consumption customers. We return to this point in our discussion of 'pooling' in chapter 5.

- Pricing freedom

  We note that adjustments to price caps aim to provide Retailers with additional pricing freedom to recoup a portion of increased market-wide bad debt costs. We are not looking to support individual Retailers. Hence to the extent that a Retailer facing higher bad debt cost levels is under priced by competitors who are better able to control such costs, this is a normal part of market functioning and by creating strong incentives for Retailers is expected to benefit customers.

[5] November 2020 CFI §3.1

Regarding the argument that pricing freedom will be ineffective, we consider that Retailers who are better able to understand and control their bad debt costs should be incentivised to develop a competitive pricing response against increased price caps in order to win new customers and maintain existing ones. We do not see why Retailers would be risk averse (and simply price up to the level of increased price caps) if this risks losing customers to competitors.

- Lack of fairness

  First, we intend to adjust retail price caps with reference to average per customer costs of bad debt. We are not expecting customers subject to REC price caps to shoulder the full £ quantum of (a portion of) excess bad debt costs across the market.

  Second, increases in REC price caps aim to allow Retailers greater pricing freedom to recover a portion of market-wide excess bad debt costs. This pricing freedom already applies to Retailers, subject to competitive constraints, in respect of customers who have switched Retailer or re-negotiated a new deal with an existing Retailer.

- Uncertainty

  Uncertainty is a feature of operating in any market. We have sought to reduce regulatory uncertainty for Retailers by setting out our decision clearly and early concerning the mechanism and sharing factors. We have also indicated that we would spread the recovery over a minimum of two years, which should help Retailers serving customers not protected by price caps. We have sought to consult early and fully regarding our approach and the potential effects on Retailers. We intend to continue this through full and early consultation on the potential adjustment to the REC price caps to apply from April 2022.

- Two variants of REC adjustment. We consider that variant (i), involving a central funds approach, is likely to be relatively complex and costly to implement. The central fund will need to be administrated and again we cannot rule out that some costs associated with that would be passed to customers. Furthermore we consider that both variants (i) and (ii) would require additional monitoring and enforcement by Ofwat to ensure that all Retailers impose and collect the correct 'levy'. We do not consider such additional costs and monitoring would be proportionate, relative to the option for a uniform increase in REC price caps.

- 'True up' – we set out and seek views in chapters 5 and 6 concerning the merits of pursuing a 'true up' as well as our intended approach, where we do pursue a 'true up'.

Note we have not seen new arguments, views or evidence concerning the advantages or disadvantages of the alternative options for mechanisms we set out in our November CFI. Our March 2021 consultation (chapter 5) set our consideration of points and arguments raised in respect of the alternative options.

4. Sharing parameters

4.1 Introduction

In April 2020 we decided that Retailers should be expected to bear bad debt costs up to at least 2% (of NHH business revenue) in full. If market-wide bad debt costs exceed 2%, we committed to provide protection for a portion (not all) of these 'excess' bad debt costs. A portion of bad debt costs in excess of 2% would be borne by Retailers and a portion would be borne by NHH customers. We ruled out Wholesalers and Household (HH) customers bearing any of these excess costs.

The use of sharing parameters to split recovery of excess bad debt costs between Retailers and NHH customers aims to balance the short and longer term interests of customers – avoiding the risk of systemic Retailer failure in the longer term whilst maintaining incentives on Retailers to manage bad debt costs and minimise additional costs on customers in the shorter term.

This section sets out our decision concerning the sharing parameters to be used in the determination of adjusted REC price caps to apply from April 2022: **On a market-wide basis, Retailers should bear 25% of bad debt costs for the part of bad debt costs in excess of 2%, and NHH customers should bear the remaining 75%.**

4.2 What we said in the consultation

We outlined our view on the preferred sharing factor regime and the sharing parameters. We reiterated our view - consistent with our April 2020 decision document - that we consider it is appropriate for excess bad debt costs to be shared between Retailers and NHH customers. We set our 'minded to' view that:

- in the event market-wide bad debt costs are 3% or lower, Retailers should be expected to bear 50% and NHH customers 50% of excess bad debt costs. So if market wide bad debt costs are 3%, excess bad debt costs are equal to (3%-2%=) 1%, which will be shared 50:50 between business Retailers and NHH customers;
- in the event market-wide bad debt costs exceed 3%, Retailers should be expected to bear 25% and NHH customers 75% of excess bad debt costs. So if market wide bad debt costs are 5%, excess bad debt costs are equal to (5%-2%=) 3%. 75% of these excess bad debt costs would be passed on to NHH customers, with 25% borne by Retailers.

We set out our view that this approach seeks to balance our policy aims of avoiding 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 also noted, in setting out proposed sharing factors, our desire to provide additional clarity for Retailers and their investors.

4.3 Consultation response summary

March Consultation Question 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).

We summarise views received as follows:

- One Retailer and two Wholesalers agreed with Ofwat's proposed approach.
- Several Retailers as well as the UKWRC reiterated their view that they were already being asked to fund an additional 1% of bad debt costs on top of business as usual bad debt costs, meaning for example that the portion above 2% to be borne by Retailers is an additional and/or unanticipated burden.
- Several Retailers proposed different approaches to sharing parameters:
    - One Retailer proposed that Retailers should be able to recover all bad debt costs in excess of 2%.
    - Three Retailers suggested omitting the proposed 50:50 element to apply to the 2%-3% part of bad debt costs, and instead suggested applying 75:25 sharing above the 2% threshold. Reasons for this view included that the proposed 50:50 element creates unnecessary complexity, as well as a perverse incentive for Retailers to let their bad debt increase above 3%.
    - Two Retailers as well as UKWRC suggested sharing factors should reflect debt recovery costs. One for example commented that if sharing factors were set at 90:10 (i.e. Retailers pass through 90% of bad debt costs to customers), debt recovery costs are generally less than 10% of the debt recovered, meaning the 90:10 parameters would still leave an incentive to collect outstanding debt from customers.
- Two Retailers as well as CCW reiterated calls for consideration for Wholesalers to share some of the burden. One Retailer said it disagreed with Ofwat's position (§6.4 March consultation) that Wholesalers are already expected to manage and bear some risks of Retailer default, arguing instead that the margins and credit protection are significantly in favour of the Wholesalers compared to Retailers.

CCW expressed its view that it does not feel appropriate for customers to bear such a large proportion of costs where these exceed the 3% threshold. One Retailer said that customers should not bear any of the costs of bad debt, and Retailers should bear the full cost of their own bad debt.

4.4 Our decision

We have decided that, **on a market wide basis, Retailers should bear 25% of bad debt costs for the part of bad debt costs in excess of 2%, and that NHH customers should bear the remaining 75%.** This will mean, among other things, that we will apply a 75:25 sharing factor to relevant excess bad debt costs in determining the adjustment to REC price caps to take effect from April 2022.

Our reasoning is as follows:

- Unanticipated burden – we have been clear since our original consideration of this issue (as set out in our April 2020 Decision document, eg. p.32, §4.1) that we would provide regulatory protections for a portion of the exposure to bad debt costs above 2% (on a market wide basis). Note we are also basing the measurement of bad debt costs over the period October 2019 to March 2021.
- We have been clear in and since our April 2020 Decision (§4.1) concerning the following:
    - The principle that Retailers are, in the first instance, responsible, and best placed, for managing bad debt risks and costs in the business retail market and that a prudent Retailer will take these risks into account, including their reasonable variation due to economic cycles and shock. Accordingly it is not appropriate to look to Wholesalers to share bad debt costs arising as a result of NHH customers failing to pay.
    - Retailers should bear some portion of outturn bad debt costs because this better meets our objectives to protect customers' interests and incentivises Retailers to continue to manage bad debt costs.
- Our 'minded to' position whereby a 50:50 sharing factor would be applied to the 2% - 3% tranche of bad debt costs, with a 75:25 sharing factor applying to bad debt costs above 2%, is complex and potentially creates incentives for Retailers to report bad debt costs in excess of 3%.
- The 75:25 sharing parameters will complement incentives on Retailers to pursue, and incur costs in, debt recovery activity.

We note concerns regarding the portion of bad debt costs above 2% that we expect to see borne by business customers. We consider our decision strikes an appropriate balance between committing Retailers to bearing costs that could not have been reasonably foreseen or planned for (and so protecting customers' longer term interests by minimising risks of systemic Retailer failure) and the need to protect customers' interests in the short term, including as a result of higher prices. We further note that our decision to commit to adjusted REC price caps applying for a minimum of two years should help attenuate the impact of any price rises for business customers.

5. Adjusting REC price caps and question of true-up

5.1 Introduction

Our March 2021 consultation invited views on the approach to adjusting REC price caps, setting out for comment:

- our view 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' (§4.2.3, consultation question 4);
- the data and information we would need to enable the setting of adjusted REC price caps (§7.5, consultation question 12);
- our approach to the revision (calculation of adjusted REC price caps using such interim data (§7.2, consultation question 9)) and three issues underpinning the revision (calculation):
  - Smoothing impacts of any price adjustment over time – §7.6, consultation question 13
  - Elements of bad debt costs to be included – §7.3.3, consultation question 10
  - Question of 'pooling' recoupment of (Retailer portion of) excess bad debt costs across customer groups – §7.4.3, consultation question 11.

In addition, the issue of how to measure bad debt costs is relevant for the calculation of the adjustment to the REC price caps. We sought views on this issue in our November 2020 CFI, §2.2.1, CFI questions 3 and 4. In the interests of expediting consideration of customer bad debt issues, particularly concerning the question of whether the 2% threshold had been reached, our March consultation deliberately omitted consideration of responses to these CFI questions.

This chapter sets out our consideration of the above questions and our decisions. Concerning the question of 'pooling' we seek further views. We have set out the chapter in three sections:

- **Section A: Data and information to estimate an initial revision to REC price cap**

  This relates to the use of available Retailer accounting data to estimate an initial revision to REC price caps to take effect from April 2022 (March consultation question 4) and the question of the data and information we are likely to need (March consultation question 12).

- **Section B: Issues underpinning the calculation of the REC price adjustment**

  This relates to March consultation questions 10 (elements of bad debt costs to be included) and 13 (smoothing impacts of any price adjustment over time). This section also includes consideration of the question of measurement of bad debt costs i.e. November CFI questions 3 and 4.

- **Section C: Outstanding issues relating to 'pooling' (March consultation question 11) and the question of the 'true up'.**

  We seek further views on these two topics.

Our March consultation also raised the question of when any revisions to regulatory protections should take effect from (March consultation question 5). We confirmed in our May 2021 update document that this would take effect from April 2022.

Concerning the question of the approach to the revision (calculation) of adjusted REC price caps (March consultation question 9), we return to this in the following chapter 6.

Section A – Data and information to estimate an initial revision to REC price cap

This section focuses on use of available Retailer accounting data to estimate an initial revision to REC price caps to take effect from April 2022 (section 5.2) and the question of the data and information we are likely to need (section 5.3).

5.2 Use of available Retailer accounting data to estimate an initial revision to REC price cap

5.2.1 What we said in the consultation

Our March consultation (§4.2.3) noted that revenue and where relevant debt collection processes take place over a number of weeks or months, or longer where customers experience payment difficulties or are in default. Accordingly, bad debt costs in respect of any financial year are unlikely to be capable of accurate measurement until at least six months, and perhaps more accurately, one year, after the end of the accounting period.

On this basis, we proposed that the calculation of the initial support for the excess bad debt costs would use the Retailers' accounting estimates for the year ending 31 March 2021, so as not to delay the process. We also stated our intention to undertake a 'true up' once more accurate information is available.

The 'true up' will be based on specific reporting of bad debt provisions and write-offs which may be subject to independent auditor review or other assurance processes. This final true up must be robust and ensure that the regulatory support is only applied to recover unpaid amounts that can be clearly demonstrated to have arisen alongside the difficulties arising from the pandemic. We also emphasised that should the true-up indicate that outturn bad debt costs were not above the 2% threshold we will unwind additional regulatory protections as appropriate.

5.2.2 Consultation response summary

March Consultation Question 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'?

There was general consensus from respondents that available Retailer accounting data should be used to derive the initial adjustment followed by a later true up. Reasons included simplicity, transparency and cost-effectiveness.

Respondents nevertheless also set out views concerning the use of such an approach and the 'true up' process.

- Pre and post January 2020 split - Four Retailers commented that 1 January 2020 was not an appropriate start date for the consumption period as it did not take into account the impact of the pandemic on the collectability of existing debt. Accordingly these Retailers said a much earlier date should be applied, with 1 April 2019 suggested as this aligns with companies' accounting reporting dates. Retailers noted this would also enable financial statements to be used as the source data, which will have been prepared in accordance with relevant accounting standards. They also suggested that all customer debt existing at March 2020 should be eligible for regulatory support with the apportionment being based on whether the bad debt cost is Covid-19 related or derived from business as usual events.
- Crystallisation of bad debt costs takes time - Two Retailers commented that across the sector bad debts can take several months if not years to crystallise. The start date should reflect this so as not to adversely impact Retailers.
- Consumption versus billing - Three Retailers also suggested that a recovery period based on consumption period created additional work. They suggested that we consider a period based on billing periods rather than consumption. Such an approach would enable them to use data directly extracted from their billing systems and reduce the need for further analysis.

One Retailer suggested that the process should be based on a consistent framework throughout the estimation and true up processes. Another Retailer requested that the materiality of the amounts involved be taken into account when considering the information and audit requirements in particular for the true up.

5.2.3 Our decision on using available Retailer accounting data to estimate an initial revision to regulatory protections

We have decided that, **in order to facilitate a timely preparation and analysis of the initial adjustment to the REC price caps, the accounting estimates and provisions made by Retailers in their financial statements during the years ended 31 March 2020 and 2021 should be used**. We will make initial calculations based on data and initial management information from the May 2021 RFI returns. We will issue a further RFI to Retailers in October 2021 to update the information which should incorporate any known or likely audit adjustments and latest customer collection data. There will be no audit requirement at this stage.

Regarding further views expressed, we comment as follows:

- Pre and post January 2020 split. We recognise that it may take time for Retailers to invoice customers following the period to which the service relates, and that where a customer delays payment, a further period may elapse before the customer makes payment or defaults. We also note that it would not be in customers interests were bad debt costs arising from consumption significantly pre-dating the pandemic to be measured as a bad debt cost for the purposes of providing support to Retailers. For these reasons **we have decided that any bad debt costs relating to usage before October 2019 will not contribute to the measurement of 'excess' bad debt costs.** We have therefore accommodated a longer period compared to our March consultation which set a cut-off date of January 2020.
- Crystallisation of bad debt costs. For the reasons set out above confirming our view that October 2019 is the appropriate cut-off date, we do not intend to take into account bad debt costs that relate to periods earlier than October 2019.
- Consumption versus billing. Retailer data on billing cycles provided in response to the May 2021 RFI demonstrated that Retailers pursue a diverse range of billing and payment profiles. Therefore **to maintain consistency in the measurement of the bad debt cost ratios and the Retailer recoveries we continue to reference consumption rather than billing**.
- Consistent framework. Chapter 6 sets out how we intend to measure bad debt costs for the purposes of setting an interim adjustment to REC price caps from April 2022, and how – where we choose to pursue this - we would implement a 'true up'. We believe this represents a consistent framework for the approach to setting an interim adjustment to REC price caps.
- Materiality – section C below seeks views on whether it may be worthwhile or proportionate to pursue a 'true up'. Part of our consideration here will include the materiality of the amounts involved.

5.3 Data and information we will need

5.3.1 What we said in the consultation

Our March consultation (§7.5) set out an initial view of the data and information we would likely need to collect from Retailers to set an adjustment to REC price caps. We noted that we would in April 2021 likely issue a further RFI to Retailers seeking updated data to end March 2021. We sought views as follows:

March Consultation Question 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?

5.3.2 Consultation response summary

Most Retailers were broadly supportive of the need for and their ability to provide the data and information suggested by Ofwat. Some Retailers expressed some reservations as follows:

- Two Retailers do not support a cut-off date of January 2020 which separates out bad debt based on when services were delivered or billed. Another Retailer commented that the normal lags between usage and billing and between billing and (non-)payment are such that a January 2020 cut-off makes its calculation complex and the resulting estimation arbitrary.
- Data relating to when a customer is billed is more readily available for the purposes of comparison to bad debt costs than data relating to the period of usage.
- Data split by customer class can be done by customer bill date, but where data relates to period of usage, this cannot be split by customer class.
- There may be constraints around the level of data available in relation to unique customers rather than SPIDs/premises.
- Data relating to financing of working capital – Ofwat should bear in mind the opportunity cost, as well as the absolute financing cost.

CCW commented that there is merit in asking Retailers to document the reasons why debt has been written off.

5.3.3 Our decision

Responses to the March consultation have not indicated that we should significantly alter our data and information requirements for the purposes of setting adjustments to the REC price caps to apply from April 2022. Accordingly in May 2021 we sought an updated RFI from Retailers concerning the main data elements we had set out in the March consultation.

Notwithstanding respondents' broad agreement with our data and information requirements, we nevertheless note that consultation respondents raised the following points, and we address them as follows:

- Data for pre and post January 2020. We have addressed this point in section 5.2.3 above, where we set out that for the purposes of any true up, we would look to measure bad debt costs on the basis of usage over the period October 2019 to March 2021.
- Consumption versus billing. We have set out in section 5.2.3 above our preference to measure bad debt costs on the basis of period of consumption rather than time of billing.
- Data sets by discrete customer group. Noting, and subject to confirmation of, our revised preference to 'pool' excess bad debt costs (see section 5.7), we consider it will not be necessary to seek Retailer data for each discrete customer group (i.e. by customer group one, two and three).
- Data availability for unique customers – we seek among other things data on the number of customers or billing accounts. While we recognise that not all Retailers have billing systems that necessarily deliver this information as a matter of course, we have nevertheless requested and sought such data from Retailers since market opening as part of our regular programme of market monitoring. We expect on this basis that Retailers should be able to report on customer numbers or billing accounts.
- Data relating to financing of working capital – we will look to formulate our data request in ways aimed at enabling us to assess an efficient cost of finance. Section 5.5 sets out more of our thinking on this point.

Taking into account these points, **we plan to seek further data and information from Retailers after September 2021**, with a view to setting the adjustment to REC price caps that will apply from April 2022. The data set sought will be similar, but not identical, to that set out in Table 4 of our March consultation and in the May 2021 RFI.

Section B – Issues underpinning the calculation of the REC price adjustment

This section sets out our decisions on two issues underpinning the revision (calculation) of REC price caps: smoothing impacts of any price adjustment over time (see section 5.4) and elements of bad debt costs to be considered (section 5.5). We also set out consideration of the question of measurement of bad debt costs (section 5.6).

5.4 Smoothing impacts of any price adjustment over time

5.4.1 What we said in the consultation

Our March consultation (§7.6) set out our minded to position to commit to any increase in REC price caps enduring for at least two years, and for any increase to be attenuated such that any price increases faced by customers are reduced. We suggested that this approach may have advantages in terms of reducing the step change in prices that customers may face and that a commitment to an enduring allowed price increase under the REC enables Retailers to better anticipate and respond to such increases on a competitive basis. We also noted that any adjustments from our planned wider review of the REC price caps are expected to be implemented from April 2023. We sought views as follows:

March Consultation Question 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?

5.4.2 Consultation response summary

Most Retailers and a NAV who commented on this issue as well as CCW agreed that there is merit, in adjusting REC price caps, to committing to such adjustments enduring for at least two years. One Retailer qualified its support for this on the basis that the overall quantum recovered stays the same. Further views included:

- Two Retailers explicitly noted that the recovery mechanism should remain open as the period of recovery may extend beyond two years. This would enable continued uncertainty over, and enable recovery of, bad debt costs arising now and in the future, to be recognised.
- One Retailer favoured a shorter time horizon and for adjustments to be made quickly as 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. Two Retailers said they disagreed with attenuating the increase in REC price cap over two years. One said this could mean that the period over which Retailers' costs are recovered are extended beyond the period over which bad debt costs accrue, and so would be inconsistent with the approach taken by Wholesalers' recovery of their Covid-19 costs, where there was no expectation that Wholesalers would delay recovery in order to minimise the impact on customers. Another set out its disagreement on the grounds that Retailers would be bearing bad debt at twice the historic level; and that there would be significant lags between estimation or write off and recovery.

5.4.3 Our decision

We have decided that any adjustments to the REC price caps should apply for a minimum of two years. We would set the adjustment with a view to enabling Retailers to recoup over at least two years the (Retailer portion of) excess bad debt costs incurred. Our reasoning is as follows.

First, the approach will attenuate the step change in prices that customers will experience and so better meet our objective to protect customers' interests. This point also applies in the case where recovery of Retailers' costs is extended beyond the period over which bad debt costs accrue.

Second, a commitment to an enduring allowed price increase under the REC enables Retailers better to anticipate and respond to such increases on a competitive basis. This thereby meets our objective to promote efficiency, including that any approach or mechanism should not distort competition or competitive outcomes.

Regarding respondents' views that the recovery mechanism should remain open, and that there would be significant lags between estimation or write off and recovery: we have committed to a wider review of REC price caps, to take effect from April 2023. We will include within that a further developed view on the appropriate level and treatment of customer bad debt costs likely to arise.

5.5 Elements of bad debt costs

5.5.1 What we said in the consultation

Our March consultation (§7.3) noted that it will be relevant in amending the REC price caps to take into account amounts Retailers have provided for or written off during the financial year 2020/21 in respect of usage since January 2020. We sought views on whether 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. We sought views as follows:

March 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?

5.5.2 Consultation response summary

Two Retailers welcomed Ofwat's 'minded to' position to recognise financing costs. CCW agreed that there is merit in making such an allowance as this would help ensure that

Retailers can finance their functions whilst recovering bad debt costs. However, CCW also caveated this view, noting for example that Ofwat would need to demonstrate that such an allowance is soundly based.

Respondents' views covered the following points:

- Two Retailers said the working capital issue was broader than slippage in debtor collection as revenue for Retailers had decreased more sharply than Retailer payments to Wholesalers for settlement charges. Three Retailers recommended an analysis of movements in debtor days to better identify the additional working capital requirements.
- Three Retailers suggested that finance costs for increased bad debt costs would be significant and/or above business as usual finance costs.
- Uniform versus non uniform allowance
  - Non-uniform – Four Retailers suggested that each Retailer should be allowed and able to evidence its costs of finance according to its individual circumstances.
  - Uniform – Two Retailers and two Wholesalers suggested a uniform interest rate or cost of capital across all Retailers could be defined and applied.
- One Retailer suggested efficient finance costs of bad debt should be the effective interest rate method which spreads the interest income or expense over the life of the financial asset or liability and is an effective way of estimating the cost over the Covid-19 period.

5.5.3 Our decision

We have decided that efficient working capital costs should be allowed, and that these relate to the (efficient) 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.

Our May 2021 update document set out our early clarification concerning the efficient financing costs of bad debt noting 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 i.e. from April 2022.

We confirm that position here. 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 through to the period in which they are recovered with the calculation of the interest recovery taking into account the effective amounts owed by customers. In the present context this would mean the financing of excess bad debt costs that have arisen in 2020-21. We would look to estimate a single efficient financing cost which we would apply to (the Retailer portion of) excess bad debt costs in determining the adjustment to REC price caps to take effect from April 2022.

Our reasoning, including our consideration of views put forward, is as follows:

- Scope of working capital costs

  We have been clear that we are looking to amend regulatory protections in favour of Retailers where customer bad debt costs, on a market wide basis, exceed 2%. Our stated policy objective here is to protect business customers, including from the risk of systemic Retailer failure. Furthermore, our suite of measures intended to help protect business customers and the market more widely from the consequences of the pandemic, introduced during 2020, included liquidity support for Retailers intended to assist with any increased need for working capital as a result of reduced receipts from end customers. Accordingly we do not see that additional support, including through adjustment to the REC price caps, is required in respect of more general changes in working capital requirements that may have arisen as a result of the pandemic.

  We do however recognise that where Retailers have seen bad debt costs in excess of the 2% threshold, but where regulatory protections have not yet been revised in ways that enable Retailers to recoup such costs, it will be appropriate to allow the efficient financing costs of (the Retailer portion of) such excess bad debt costs up to the point in time at which revised regulatory protections come into effect, i.e. April 2022.

- Financing costs will be higher than business as usual

  We will assess Retailer data and evidence on this point following receipt of Retailer data concerning financing costs as part of the October RFI.

- Uniform versus non-uniform

  Our approach to revising regulatory protections aims at giving Retailers increased pricing freedom via adjustment to REC price caps. For the reasons set out at section 3.4, it is not our intention to tailor recovery of Retailer costs to each Retailer's individual circumstances. Accordingly we see no justification for tailoring finance costs (e.g. interest rate paid) to each Retailer's individual circumstances.

5.6 Measuring bad debt costs

If we decide to undertake a 'true up', we need to establish how to accurately measure bad debt costs that have arisen and so cross check initial estimates used for the purposes of setting the adjustment to the REC price caps. Our November 2020 CFI (§2.2.1) in particular outlined two approaches: (i) a statutory accounts basis, and (ii) a non-statutory accounts basis and sought views via CFI Questions 3 and 4. Furthermore, our March 2021 consultation (§2.1, §4.2.3, §7.3.3) set out our initial view that the measurement of bad debt costs and the final ‘true up’ should be robust taking into account only amounts Retailers have provided for or written off in respect of usage since January 2020.

Hence, noting our policy intent to exclude from the measurement of bad debt costs arising on usage prior to October 2019, we have decided that, **for the purposes of any ‘true up’, we will need a more prescriptive and quality assured process to ensure that bad debt costs reported by Retailers are consistently measured and represent a reasonable estimate of the bad debts arising since the implementation of Covid-19 measures.** That is, we prefer a non-statutory accounting basis. Accounting standards require judgement in their application, such as when to recognise provisions, and the ‘true up‘ is seeking to remove such areas where judgements are applied. Annex 1 sets out our consideration of consultation responses and our reasoning.

Section C Issues relating to ‘pooling’ and the question of the ‘true up’

We have not reached definitive conclusions and seek further evidence and views from stakeholders in relation to: pooling of bad debt costs across customers with varying levels of usage (see section 5.7); and whether to undertake a formal ‘true up’ process if outturn levels of bad debt are not materially greater than the 2% threshold (see section 5.8). **We seek further views on these two topics.**

5.7 Pooling

5.7.1 What we said in the consultation

Our March consultation (§7.5) set out that an adjustment to REC price caps could be a single uplift which reflects (a portion of) excess bad debt costs arising across the market. This uplift would not differentiate between or try to apportion bad debt costs between for example different customer groups or geographic regions and so would represent a ‘pooled’ approach. We set out that we see some merit in such ‘pooling’ because we don’t see any compelling evidence of materially different effects across different customer groups.

Nevertheless a non-pooled approach under which bad debt costs are recovered according to the customer groups set out under the REC price caps might have merit[6]. We noted here that customer groups are broadly defined into the three groupings and customer characteristics and costs better understood.

[6] The REC price cap identifies three customer groups according to annual water consumption: Group One 0 - 0.5Ml; Group Two 0.5Ml - 50Ml; and Group Three greater than 50Ml

We also said that in adjusting REC prices, we would also look to exclude bad debt costs arising in respect of customers with annual consumption exceeding 50Ml (i.e. Group Three customers), as such customers are not subject to maximum price caps, which would call for the separate identification and exclusion of outturn bad debt costs associated with this customer group.

We said that we were minded to measure and enable 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. However we also noted that we seek stakeholder views on both options. We sought views as follows:

March Consultation Question 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.

5.7.2 Consultation response summary

Respondents were divided concerning the merits of 'pooling':

- Five Retailers and two Wholesalers said that they favoured not 'pooling', or saw some merit in Ofwat's 'minded to' position. One Retailer commented that this would help reflect the differential effect of the pandemic on the two groups and hence it is fairer between customer groups where bad debt is more and less concentrated and between Retailers whose customers are preponderantly in one group or the other. Another Retailer commented that 'pooling' not only creates an effective cross-subsidy of risk but also potentially raising questions of anti-competitive pricing.
- Three Retailers and one NAV as well as CCW said they favoured pooling bad debt across customers. Reasoning included views that separately targeting recovery from the lower consumption customers means higher price rises for those customers who have been hardest hit. One Retailer also noted that this approach would ease the risk of error in estimating relevant excess bad debt costs for specific customer groups. One Retailer noted its view was on the basis that Ofwat has seen no compelling evidence with regards to the differential in the costs to recoup debt and the significant diversity within customer Group two.
- One Retailer reiterated its view that individual Retailers should bear the full cost of their own bad debt.

5.7.3 We seek further views

We have not reached a definitive decision concerning whether excess customer bad debt costs arising for all customers (i.e. Customer Groups One, Two and Three) should be 'pooled' in some manner. However, taking into account respondents' views and our reasoning set out below, we are minded to consider pooling all customer bad debt costs across Groups One, Two and Three to calculate an average market-wide uplift to the REC price caps across all Customer Groups. Our thinking here represents a development from that set out in the March 2021 consultation. Our reasoning is as follows.

We consider that pooling excess bad debt costs arising for all Customer Groups to calculate an average market-wide uplift to the REC price caps should better promote efficiency, in that the data and information for bad debt costs is more reliable and verifiable at a pooled level. It also reduces burdens on Retailers to identify and estimate bad debt costs by customer group, so contributing to our third objective to provide clarity and minimise implementation costs.

Regarding the view that 'pooling' not only creates an effective cross-subsidy of risk but also potentially raising questions of anti-competitive pricing, we consider that the adjustment to REC prices to take effect from April 2022 in respect of bad debt costs will be minor and temporary. Furthermore, we have committed to revise regulatory protections where market-wide customer bad debt costs exceed 2% of NHH revenue. The 2% threshold, and the basis for any regulatory support are averages across the market (i.e. across Customer Groups One, Two and Three). Following this logic implies that any market-wide uplift to the REC price caps should also be calculated as averages across the market (i.e. across Customer Groups One, Two and Three) to ensure consistency in identifying the need for, and application of, additional regulatory protections.

Consultation Question 1 – We are presently minded to 'pool' (the customer portion 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?

5.8 Proportionality of pursuing a 'true up'

Our key rationale for introducing and pursuing a 'true up' was to better meet our objectives to ensure customers' interests are best protected, i.e. by ensuring any excess bad debt costs passed to them are measured consistently by all Retailers. We note this approach would involve implementation costs for Retailers, particularly in terms of providing a more detailed and quality assured examination of bad debt costs. This would then meet our third objective less well, which sets out that any approach should seek to minimise implementation costs.

In the light of experience, we put the question of whether this balance is now reversed. Retailer data so far indicate that although the threshold for additional regulatory support has been reached, it has not been significantly exceeded, with the data indicating the level of support would be ≈0.5% of market turnover across 2020-21. This suggests the likelihood of error and hence passing through to business customers a too large quantum of excess bad debt costs via adjustment to REC price caps is much reduced, particularly after application of sharing factors. On the other hand, the verification and implementation burden for Retailers as part of a 'true up' would remain.

Hence we are presently minded - subject to views – to remain open to the idea of not undertaking a formal 'true up' process if outturn levels of bad debt are not materially greater than the 2% threshold. Instead we would take into account a revised view on the level of bad debt costs Retailers are facing as part of our wider review of the REC. We would take a final view on whether or not to pursue a 'true up' after analysis of updated Retailer data on bad debt costs, which we would seek via an RFI in October 2021.

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

6. Implementing our decisions

6.1 Introduction

We have set out our decision that, in the light of Retailer reported bad debt costs for 2019-20 and 2020-21, revisions to regulatory protections are warranted (chapter 2) and that these should take the form of adjustments to REC price caps to take effect from April 2022 (chapter 3 and our May 2021 update document). We have set out our decision that Retailers should bear 25% of excess bad debt costs, and pass through 75% of these to business customers (chapter 4). We have further set out a number of considerations for calculating the adjustments to apply to REC price caps as well as seeking further views on the merits of 'pooling' and whether or not it may be proportionate to pursue a subsequent 'true up' (chapter 5).

This chapter sets out our intended approach concerning how we will bring these elements together to implement our decisions. It sets out:

- How we intend to calculate the adjustments to REC price caps to apply from April 2022 (section 6.2); and
- Should we choose to implement it, our process and method for pursuing a 'true-up' (section 6.3). We seek further views and evidence on this point (see consultation question 3).

Note, as set out in our May 2021 update document as well as next steps chapter in this document, it is our intention by end of 2021, and taking into account the approach set out here, to consult more fully on the proposed quantum of adjustments to apply to REC price caps from April 2022, with a view to publishing a Decision by end February 2022.

6.2 Approach to setting interim adjustment to REC price caps

6.2.1 What we said in the consultation

Our March consultation (§7.2) set out how we would look to adjust the REC price caps on the basis of industry wide costs. This included that we would need to collect cost data and information from Retailers. We further set out that our adjustment to the REC price caps would likely take the form of increments to the margins under the REC. We indicated that we expected to confine attention to excess bad debt costs arising for customers with annual consumption below 50Ml. The increment would be set such that – on a market wide basis - the portion of excess bad debt costs (i.e. in respect of all customer <50Ml) applying to customers on price controlled tariffs would be recouped via the increment. Put differently, customers on REC price controlled tariffs would not bear the full quantum of (the customer portion of) excess bad debt costs applying to all customers below 50Ml. We also indicated that we would need to consider 'pooling' bad debt costs and smoothing the recoupment over at least two years, noting that we would consider these points separately (as detailed here below).

We sought views as follows:

March Consultation Question 9: Do you have views concerning the approach to setting the revision of the REC price caps with respect to excess bad debt costs?

6.2.2 Consultation response summary

Two Retailers set out their support for Ofwat's proposed approach. Another Retailer reiterated its view that individual Retailers should bear the full cost of their own bad debt. Other views expressed were:

- Two Retailers expressed concerns about measuring bad debt costs on the basis of when services are provided, and about Ofwat's proposal to split information on bad debt costs into pre and post January 2020, which one said could exclude earlier charges for periods that would normally be expected to be collected.
- Enable each Retailer to recoup its own costs – one Retailer said that the approach should be amended such that each Retailer recoups excess bad debt costs that it incurs.
- Fixed element of tariffs – one Retailer said that its interpretation of Ofwat's uniform uplift to REC price caps is that this means it is likely that the fixed element of tariffs will be increased and commented that the application of a percentage increase will add administrative burden and reporting to assess the recovery of REC changes on a variable basis.
- One NAV commented that it remains unclear how a NAV not covered by the Retail or Wholesale price control process would be able to recover increased bad debt costs in line with Ofwat's general principles, and said it believes that the final mechanism should allow for this.

6.2.3 Our decision concerning approach to adjusting REC price caps

Views expressed have not caused us to alter our basic approach to adjusting REC price caps as set out in our March consultation (§7.2). Concerning the view or views:

- expressed on the measurement of bad debt costs, we have set out our views on this point in section 5.2.3.
- that we should amend the approach such that each Retailer recoups excess bad debt costs that it incurs, we have set out our views in section 3.4.

- regarding the fixed elements of tariffs, it is our intention, as set out below, to amend the net and gross margins applying in the REC such that maximum allowed prices are increased. Retailers have freedom to price, including adjusting the structure of tariffs, providing prices remain below the cap.
- concerning NAVs not covered by the Retail or Wholesale price control process, NAVs are subject to REC price caps by reference to Condition B of their appointments. Where the relevant Retailer increases its charges, NAVs would also be able to do so meaning that REC price cap increases may also be relevant to NAVs.

In setting out our approach to adjusting REC price caps, we have reflected our decisions as set out in chapter 5. We note that we have not yet reached a Decision concerning 'pooling' and that consequently our approach to adjusting REC price caps at this stage will need to be flexible to our subsequent decision on this point.

Note we work to the assumption that adjustments to the REC price cap to take effect from April 2022 and any subsequent 'true up' will be a 'one-off' exercise. That is, we will measure any excess bad debt costs that have arisen across the market on the basis of the period from 1 October 2019 to 21 March 2021. Adjustments to REC price caps taking effect from April 2022 will be calibrated to enable Retailers – on a market wide basis – additional pricing flexibility in respect of the Retailer portion of excess bad debt costs. Note this approach does not rule out taking into account any relevant adjustments from April 2023 – for example as a result of any 'true up' - and following our wider review of REC price caps.

As a result, we presently anticipate the process for calculating the adjustment to apply to REC price caps from April 2022 as follows:

Box 2 –
Anticipated process for calculating the adjustment to apply to REC price caps from April 2022

(i) October 2021

- Retailers return October 2021 RFI with:
  - Data to March 2021 updated and consistent with audited accounts or based on best estimates thereof. Anticipating the possibility of a 'true up' exercise, data would also include a split of bad debt costs between consumption before and after 1 October 2019.
  - Data and information concerning financing costs.

(ii) by December 2021

- Ofwat consults on proposed adjustment to REC price caps to apply from April 2022, with proposed adjustment expected to be calculated on following basis:

  (A) Assess £m excess bad debt costs plus efficient financing costs to be recovered from the market, as follows:
  - Estimate proportion of outturn bad debt costs applying in 2020-21. On this basis we take the view that it is appropriate to measure industry wide outturn bad debt costs applying in 2020-21 as the weighted average applying across 2019-20 and 2020-21. On the basis of Retailer reported data, this at present gives an estimate of market wide outturn bad debt costs of 2.5%.
  - Estimate efficient financing costs for Retailers carrying the (Retailer portion of) excess bad costs
  - Noting the 2% threshold, our current estimate of bad debt costs of 2.5% and the 75% sharing factor, we would on this basis look to calculate excess bad debt costs to be recovered by Retailers as:
    £m = (2.5%-2.0%) x 0.75] x annual market turnover for 2020-21
    + Estimated efficient financing costs

  (B) Calculate uplift to REC price caps, assuming excess bad debt costs are 'pooled' over all business customers, as follows:
  - Calculate uniform uplift to net margins and gross margins for customer Groups One and Two with the increase calibrated such that if the uplift applied to all customers (price controlled and non-price controlled), then Retailers in aggregate would recoup the excess bad debt costs to be recovered as set out under (a).

  (C) Uniform uplift would also be calculated so as to:
  - spread recoupment over two years

(iii) by February 2022

- Ofwat publishes Decision document setting out adjustments to REC price caps to apply from April 2022.

6.3 Approach to 'true up'

6.3.1 Introduction

Chapter 5 sought views on the merits of pursuing a 'true up'. This would be on the basis that any measurement of bad debt costs and revisions to regulatory protections takes place relatively soon after the period over which excess bad debt costs may arise but on the basis of management information. A subsequent 'true up' would review the initial assessment at a later date using a defined approach to the measurement of bad debt costs. The process would also require an independent review of measured bad debt costs and amounts recovered by Retailers.

This chapter provides an overview of the approach to the 'true up' process we would undertake, where we decide it is warranted and proportionate to do so. This includes the timing of the 'true up' and how we see it fitting against our wider review of REC price caps, which we plan to commence later in 2021.

6.3.2 Method and approach

Should we choose to pursue a 'true up', there are two key elements to undertaking and putting it into effect:

(i) Timing of the 'true up' exercise – i.e. given that we see the 'true up' as a one off exercise, when should this take place; and

(ii) Measurement of bad debt costs arising – i.e. the methodology used to measure and check bad debt costs that have arisen for Retailers.

We set out our thoughts as follows.

<u>(i) Timing of the 'true up' exercise</u>

We anticipate that during the remainder of 2021 we will use Retailer data provided in response to the May 2021 RFI, plus updated data to be provided in response to an anticipated October 2021 RFI concerning bad debt costs arising in 2019-20 and 2020-21, to estimate adjustments to the REC price caps to apply from April 2022.

Should we pursue a 'true up', we would then look to collect, after March 2022, more detailed data from Retailers in respect of bad debt costs arising on the basis of usage between October 2019 and March 2021. We would expect this more detailed data to have been subject to relevant quality assurance processes such as an independent audit.

(ii) Measurement of bad debt costs arising

We have decided that, for the purposes of the 'true up', we would need a more prescriptive and quality assured process to ensure that bad debt costs measured by Retailers do not over represent bad debt costs arising since Covid-19 measures were put in place, i.e. we look to the costs being measured on a more consistent basis by Retailers. Annex 1 sets out our consideration of consultation responses and our reasoning.

In summary, we think:

- It is reasonable to measure bad debt costs on the basis of those that might have arisen in respect of usage between October 2019 and March 2021, rather than since January 2020 as indicated in our March consultation.
- The timing of usage, rather than billing, is the preferable basis for gauging timing of when bad debt costs may have arisen for the purposes of considering what regulatory support may be appropriate.
- Retailers should provide updated data on debtors as at 31 March 2021, value of future receipts, and debts fully written off during the period of support in order to calculate a value for bad debt costs over the consumption period October 2019 to March 2021 and compare this to the initial data already provided by Retailers. Annex 1 provides further detail concerning our rationale and this calculation.
- The true up data submitted above will require an independent audit or some other form of independent assurance and the Retailers will be required to confirm that the full bad debt cost has been reflected in their accounting records.

We therefore see this approach as appropriate:

(i) October 2021 – as part of the October RFI, we would collect data on bad debt costs for consumption pre and post October 2019.

(ii) After March 2022 –
   - collect more detailed data from Retailers in respect of actual and expected customer payments and bad debt costs arising for customer usage between October 2019 and March 2021.
   - This more detailed data should be made up to 31 March 2022 and be subject to relevant quality assurance processes such as independent audit. We will also require Retailer confirmation that this bad debt cost has been reflected in their accounting records.

(iii) On the basis of the more detailed and quality assured data in respect of bad debt costs for October 2019 to March 2021, we would pursue one of the following courses of action:
   - where the more detailed data indicate that, on the basis of the period October 2019 to March 2021, bad debt costs did not exceed the 2% threshold, we will look to unwind the adjustment to the REC price cap. We would do this by

making a corresponding adjustment to REC price caps to apply from April 2023, as part of our wider review of REC price caps.

- where the more detailed data indicate that, during the period October 2019 to March 2021, bad debt costs exceeded the 2% threshold by more than (less than) the amount calculated under (A) in Box 2 above (i.e. used to adjust REC price caps from April 2022), we would look to make a corresponding upward (downward) adjustment to the REC price cap to apply from April 2023, as part of our wider review of REC price caps. We would also look to include relevant efficient financing costs.

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

7. Next steps

In the light of our decision for revised regulatory protections to the form of adjusted REC price caps to take effect from April 2022, and our view that we will need to decide later in 2021 whether or not a 'true up' process will be needed, we have in mind the following next steps:

- Adjusting REC price caps

  We will need to consult on the proposed adjustments, followed by a Decision confirming the adjustment. To help us understand the latest position for Retailers as we consider the adjustment, we will also need to seek updates from Retailers regarding bad debt costs and other information, to end September 2021. Accordingly we plan to issue an RFI to Retailers in October 2021.

- 'True up'

  In the light of further information received from Retailers in response to the anticipated October 2021 RFI, we will update our view of industry wide outturn bad debt costs incurred during 2020-21 and make a decision whether it would be proportionate and appropriate to undertake a 'true up'.

We also plan to commence by end 2021 our wider review of REC price caps. Our intent here is that any relevant revisions in respect of this wider review take effect from April 2023. Note that to the extent we also undertake a 'true up' exercise to review our assessment of whether or not the 2% threshold has been exceeded, we think it makes sense to consider such a 'true up' as part of our wider review of REC price caps.

We currently anticipate that we would set out our intended approach to the wider review of REC price caps before the end of 2021, shortly followed by an RFI to Retailers relating to the wider REC price cap review, for completion in early 2022. We will undertake further work during 2022 to inform our wider review of the REC price caps and consult on a 'minded to' position later in 2022.

We therefore currently anticipate the following next steps and timetable to achieve this:

Next steps	
October 2021	• Retailer RFI, for return November 2021.
By December 2021	• Publish planned approach for our wider review of REC price caps • Publish Consultation on parameters of recovery mechanism to apply from 1st April 2022, to include our Decision on the question of 'pooling' and whether or not to pursue a 'true up'
February 2022	• Publish Decision on parameters of recovery mechanism to apply from 1st April 2022
April 2022	• Adjusted REC price caps enter into force
2022	• Consultation on wider review of REC price caps, including where relevant, 'true up'

Responding to consultation questions

Chapters 5 and 6 put the following consultation questions and seeks views:

Chapter 5 – Adjustment of REC price caps

Consultation Question 1 – We are presently minded to 'pool' (the customer portion 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?

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

Chapter 6 – Implementing our decisions

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

We are seeking views and evidence from all interested stakeholders. We welcome views on the issues relevant to consultation questions 1 to 3 by 5pm Wednesday 15th September 2021. Please submit email responses to covidbusinessretailmarket@ofwat.gov.uk, with the subject 'Customer Bad Debt July 2021 Decision and Consultation'.

You can submit your responses by post to: 'Customer Bad Debt July 2021 Decision and Consultation', Ofwat, 21 Bloomsbury Street, London WC1B 3HF.

We intend to publish responses to this consultation on our website at www.ofwat.gov.uk. Subject to the following, by providing a response to this consultation you are deemed to consent to its publication.

If you think that any of the information in your response should not be disclosed (for example, because you consider it to be commercially sensitive), an automatic or generalised confidentiality disclaimer will not, of itself, be regarded as sufficient. You should identify specific information and explain in each case why it should not be disclosed and provide a redacted version of your response, which we will consider when deciding what information to publish. At a minimum, we would expect to publish the name of all organisations that provide a written response, even where there are legitimate reasons why the contents of those written responses remain confidential.

In relation to personal data, you have the right to object to our publication of the personal information that you disclose to us in submitting your response (for example, your name or contact details). If you do not want us to publish specific personal information that would enable you to be identified, our *Privacy policy - Ofwat* explains the basis on which you can object to its processing and provides further information on how we process personal data.

In addition to our ability to disclose information pursuant to the Water Industry Act 1991, information provided in response to this consultation, including personal data, may be published or disclosed in accordance with legislation on access to information – primarily the Freedom of Information Act 2000 (FoIA), the Environmental Information Regulations 2004 (EIR) and applicable data protection laws.

Please be aware that, under the FoIA and the EIR, there are statutory Codes of Practice which deal, among other things, with obligations of confidence. If we receive a request for disclosure of information which you have asked us not to disclose, we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances.

In developing this document, we have used information and evidence already obtained, including responses to our March 2021 consultation and via requests for information from Retailers. We welcome the constructive discussions thus far and the set of questions for consultation in this document is an opportunity for stakeholders and any interested parties to provide further views and perspectives.

A1 Annex 1 – Measurement of customer bad debt costs for purposes of 'true up'

A1.1 Introduction

This Annex sets out our consideration of the issue of the measurement of bad debt costs for the purposes of undertaking a 'true up', should we decide to pursue this.

This Annex also includes consideration of responses to questions 3 and 4 concerning measurement of bad debt costs in our November Call for Inputs (CFI) document. In the interests of expediting consideration of customer bad debt issues, particularly concerning the question of whether the 2% threshold had been reached, our March consultation omitted consideration of CFI questions 3 and 4. We have instead summarised and considered responses below.

A1.2 Measurement of customer bad debt costs for purposes of 'true up'

A1.2.1 Introduction

We have indicated that we will use Retailer data provided in response to the May 2021 RFI, plus updated data to be provided in response to an anticipated October 2021 RFI concerning bad debt costs arising in the years ended 31 March 2020 and 2021, to estimate adjustments to the REC price caps to apply from April 2022. We have relied on Retailers own judgements and accounting conventions to report outturn bad debt costs for these years.

For the purposes of any 'true up', we will need a greater granularity of data to verify bad debt costs incurred, and to be more prescriptive about what bad debt costs are permissible and which are not. We have previously[7] in particular said that we wish to take into account bad debt costs that arise only in respect of usage since January 2020. We note that our November CFI also sought views on the measurement of bad debt costs as follows:

> **November 2020 CFI Question 3 – What is your view on the best approach to measure bad debt costs arising, in ways that are objective, consistent and verifiable?**
>
> **November 2020 CFI Question 4 – Do you agree that Ofwat should allow Retailers to determine the basis on which they report bad debt costs (provided that it complies with relevant accounting standards)? Alternatively, should Ofwat set out a more prescriptive**

[7] E.g. March 2021 consultation document

and defined basis for the determination and reporting of bad debt costs? Please set out the basis for your view or conclusions.

Concerning the question of confining bad debt costs that arise in respect of usage since January 2020, we have received views in response to the March 2021 consultation as summarised in Chapter 5, and set out our Decision concerning this in section 5.2.3.

Concerning our November CFI questions 3 and 4, we summarise responses as follows:

Retailers and most Wholesalers who responded to these questions generally expressed a preference for measuring bad debt costs on the basis of existing accounting conventions, which have been subject to audit and quality assurance processes. They would like an expected values basis as required by accounting standards rather than the alternative approach which states that in order to correctly capture the Covid-19 impact there needs to be a stated set of principles. One Wholesaler in answer to question 4 for example said that it considered having a more prescriptive and separate basis for the reporting of bad debt costs will increase complexity and cost without necessarily producing more robust results. Other respondents in general opined that existing accounting standards and practices should be adequate to ensure equity of comparison and approach. Retailers in general expressed recognition of the need for a subsequent true up to correct the estimates made and to take account of any subsequent recoveries.

One Retailer commented that under IFRS 9 and FRS 102 bad debt is recognised when there is evidence that a customer or group of customers will not pay, based on when that evidence arose, rather than relating to when the service was provided. This Retailer went on to comment that it does not see why anything other than well-established accounting standards should be used to define bad debt costs (whether IFRS 9 or FRS 102), where bad debt is recognised when there is evidence that a customer or group of customers will not pay, based on when that evidence arose rather than relating to when the service was provided. One Retailer said that Retailers should be given a set of criteria that must apply to a debt balance for it to qualify to be included in the recovery mechanism.

CCW said that it is preferable for Ofwat to be prescriptive for example in order to avoid Retailers reaching different conclusions of what would constitute 'bad' or 'doubtful' debt for the purposes of reporting. Several Wholesalers as well as a NAV said for the purposes of determining regulatory assistance they favoured a more prescriptive approach and/or application of a more explicitly defined measure, for example so as to cover concerns of objectivity and consistency. One respondent proposed that no remittances received within the 2 months prior that could indicate slower payments be included.

We respond to these points and set out our decision concerning the measurement of bad debt costs for the purposes of the 'true up' as follows.

A1.2.2 Our approach to measuring bad debt costs for the purposes of ‘true up’

We anticipate that the ‘true up’ process, should we choose to pursue it, will adopt a consumption period and a defined methodology for the measurement of Covid-19 related bad debt costs.

Our initial suggestion was that this period should start from 1 January 2020 to allow for a reasonable collection period. However given the typical billing and credit cycles within the business retail sector and in light of views received suggesting that the pandemic could have affected customer payments relating to usage before January 2020 we have decided to base measurement of bad debt costs concerning non-payment of services provided from 1 October 2019 to 31 March 2021. This acknowledges that the pandemic has had an impact on the collectability of debt existing in March 2020 but only allows support for debts incurred within a reasonable collection period before the pandemic.

The responses to the May 2021 RFI as well as other data and information made available to us indicate a wide range of bad debt costs being identified by Retailers. We note that to a lesser or greater extent, this range may reflect variations in the application of accounting policies. Since we are looking to customers to bear a portion of excess bad debt costs and hence to ensure customers’ interests are protected, we need, as far as possible, to remove the application of judgement and align the Retailer bad debt costs on similar bases. Accordingly we have adopted a prescriptive approach to the ‘true up’ which should give more consistent and comparable bases for cost and timing.

A1.3 Proposed methodology

We set out our proposed methodology for the measurement of bad debt costs for the ‘true up’ below. The ‘true up’ seeks to measure accurately the bad debt cost arising on service usage for the period 1 October 2019 to 31 March 2021.

Following year end March 2022, Retailers should provide the following information:

i. Debtors as at 31 March 2022 arising from services from 1 October 2019 to 31 March 2021

   i.e. all outstanding balances due from customers at 31 March 2022 in relation to services provided for the consumption reference period i.e., 1 October 2019 to 31 March 2021;

ii. Value of future receipts

i.e. sum of:

- cash payments the Retailer is expecting to receive from its customers in relation to the amounts owed above such as on-going payment plans; and
- any expected further proceeds which may include sale of the debt to recovery specialists or possible debt factoring arrangements;

iii. Debts fully written off during the period

i.e. a record of all debts relating to the consumption period which have been fully written off in the Retailer's accounting records in relation to services provided during the consumption reference period.

This will give a value which represents the value of irrecoverable debts outstanding for services provided during the consumption period.

We will also require confirmation that the cost of the irrecoverable debts has been reflected as a bad debt cost in the Retailer's accounting records.

This value of irrecoverable debts is then expressed as a percentage using the total revenue for the period from 1 October 2019 to 31 March 2021 (Gross level of bad debts).

A worked example is shown in table 2 below.

Table 2 – Example of true up methodology

Example of True-up calculation (values are for illustrative purposes only)	£'000
Debtors as at 31 March 2022 arising from services from 1 October 2019 to 31 March 2021	65,000
Value of anticipated future receipts for the above debtors	(5,500)
Debts fully written off during the period arising from 1 October 2019 to 31 March 2021	3,000
Irrecoverable debtors as at 31 March 2022 relating to the consumption period 1 October 2019 to 31 March 2021	62,500
Revenue for the period 1 October 2019 to 31 March 2021	1,500,000
Bad debt %	4.2%
Amount borne by Retailers	(2.0%)
Gross excess bad debts eligible for regulatory support	2.2%
Support already given (Gross pre sharing mechanism)	(1.0%)
Additional support (Gross pre sharing mechanism)	1.2%

A2 Annex 2 - Consultation questions

Chapter 5 – Adjustment of REC price caps

Consultation Question 1 – We are presently minded to 'pool' (the customer portion 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?

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

Chapter 6 – Implementing our decisions

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

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

Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA
Phone: 0121 644 7500

This document is also available from our website at www.ofwat.gov.uk.

Any enquiries regarding this publication should be sent to mailbox@ofwat.gov.uk.