October 2021

October 2021 Update: Business retail market – Customer bad debt

1. Introduction and purpose

Ofwat in July 2021 published a joint decision and consultation document on customer bad debt in the business retail market. The document (§1) reiterated our objectives concerning the issue and treatment of customer bad debt in the business retail market.

We set out our decision that, on the basis of information provided by retailers indicating outturn bad debt costs for 2019-20 at an industry level of around 2.9%, and for 2020-21 around 2.1%, revisions to regulatory protections are warranted, and that these should take the form of an adjustment to the REC price caps from April 2022. We further set out our decision that Retailers should bear 25% of bad debt costs for the part of bad debt costs in excess of 2%, and that non-household (NHH) customers should bear the remaining 75%. We set out that we had made our decisions on the basis of best meeting our objectives.

Our July 2021 document also sought further views on two issues; it put one consultation question relating to the issue of 'pooling'; and two relating to the issue of a 'true-up'. We received responses from seven Retailers and one from CCW, the Consumer Council for Water.

This update document sets out our decision concerning the question of 'pooling', i.e. the question of whether (excess) customer bad debt costs should be pooled and recouped across all NHH customer groups or whether bad debt costs arising for a particular NHH customer group should be attributed to, and recouped from, that NHH customer group.

Following receipt of responses to the July 2021 document, this update document sets out our decision to pool (the NHH customer portion of) excess bad debt costs across all NHH customers. We will apply a correspondingly uniform uplift to REC price caps. (See section 2 below).

We are publishing this decision now because our approach to pooling will determine the detailed data breakdown in the Request for Information (RFI) that we intend to send to Retailers in early October 2021. Since we have decided to pool excess bad debt costs across all NHH customer groups, our RFI will not seek detailed data on bad debt costs by individual NHH customer group.

Concerning the question of a 'true up', in the July 2021 document we said 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. We therefore plan to return to this point later in the year.

Two respondents to the July 2021 document also raised concerns that Ofwat's planned timetable for publishing its decision on adjustments to REC price caps to apply from April 2022 corresponds poorly with Retailers' timetable for revising and communicating price changes to customers. While we did not formally consult on this point in our July 2021 document, we nevertheless acknowledge points raised and return to this point in section 2.

2. Our decision regarding 'pooling'

What we consulted on in the July 2021 document

Our July 2021 document (§5.7) set out our discussion of 'pooling'. We recalled that in setting an adjustment to REC price caps to apply from April 2022, this could be on the basis of a single uplift to REC price caps which reflects (a portion of) excess bad debt costs arising across the market. Where this uplift does not differentiate between or try to apportion excess bad debt costs between for example different NHH customer groups or geographic regions, it would represent a 'pooled' approach. A non-pooled approach by contrast would assign and recover excess bad debt costs from particular NHH customer groups. We particularly discussed possible merits of assigning and recovering excess bad debt costs on the basis of the NHH customer groups as set out under the REC price cap (i.e. Customer Groups One, Two and Three)[1].

We said that we had not reached a definitive decision on whether to pool excess customer bad debt costs arising for all NHH customers in some manner, but we were minded to pool all (excess) 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.

We said we thought that this approach would better meet our objective to promote efficiency because data and information for bad debt costs is more reliable and verifiable at a pooled level. We also thought it reduces burdens on Retailers of identifying and estimating bad debt costs by NHH customer group, thus helping to provide clarity and reduce implementation costs.

We also noted that, 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. We also thought that the 'pooling' approach was more consistent with the 2% threshold for regulatory support in the first place which is applied as an average across the market (i.e. across Customer Groups One, Two and Three).

We consulted on the question of 'pooling' as follows:

July 2021 document 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?

[1] 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

Summary of responses

Four Retailers and CCW agreed with our minded to position to 'pool' (the customer portion of) excess bad debt costs across all (NHH) customers and apply a corresponding uniform uplift to REC price caps. Reasons given included that this would be fairer to lower consumption customers who have been hit harder, that in seeking to define 'pools' of bad debt associated with specific groups of customers, there is a risk of error, and that this approach retains simplicity. One Retailer said that it supports the intention to 'pool' excess bad debt costs, with a view that the 'averages' calculation should be equitable between the consumption bands.

Three Retailers disagreed. Reasons given included:

i. Two Retailers thought that the evidence suggests that Customer Group Three customers have contributed significantly and proportionately less to the debt risk. One of these Retailers also suggested that (assuming this is the case) it is not fair or reasonable for these customers to cross-subsidise the lower consumption customers. It thought that it would be clear and simple to identify and exclude Group Three costs, consistent with Ofwat's objectives.
ii. One Retailer noted that Ofwat has previously made clear that Retailers of customers outside the retail price control (either due to being contracted customers or within the large customer segment, which is no longer price regulated) do not require any changes to regulation to allow prices to reflect the increased risk of bad debt. This Retailer argued that higher volumetric customers, which have, proportionately, seen the lowest Covid-19 related bad debt costs and for which Retailers already have pricing freedom, should be excluded from the relevant adjustment to the REC price caps in respect of bad debt costs.
iii. Pooling would disadvantage Retailers that primarily serve customers that fall within a single REC defined customer group.

Two Retailers said that they therefore believe that the proposal should revert to the option previously discussed[2] of pooling Customer Groups One and Two (0-0.5Ml and 0.5-50Ml), while treating Customer Group Three (>50Ml) differently.

Ofwat view

We remain of the view that there is, on balance, merit in pooling excess bad debt costs across all NHH customer groups and setting a uniform uplift to REC price caps such that, on average, retailers may recoup the relevant portion of excess bad costs were all NHH customers (price controlled and non-price controlled) to face a similar uplift to prices. **Consequently, we have decided, in setting adjustment to apply to REC price caps from April 2022, to 'pool' (the**

[2] See for example §7.4 Ofwat's [March 2021 consultation document]()

customer portion of) excess bad debt costs across all NHH customers and apply a corresponding uniform uplift to REC price caps.

Our reasoning remains similar to that set out in our July 2021 document. In particular, we have been consistent in setting out our view that regulatory support may be warranted where on a market wide basis, outturn bad debt costs exceed 2% of turnover. In particular, our April 2020 Decision document (§4.1) set out our decision that Retailers should be prepared to bear outturn bad debt costs to a level equivalent to 2% of their retail business market turnover, on the basis that industry-wide doubtful debt costs in 2009/10, i.e. immediately following the financial crisis, were around 1.5%.

This 2% threshold for determining whether regulatory support may be warranted was therefore set with reference to a market-wide average and it follows 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.

Alternatively we would need to adopt a measure of prudently anticipated bad debt for individual NHH customer groups, with a view to determining a threshold level for regulatory support for each NHH customer group in question. Based on the submissions from Retailers, this could be higher than the 2% average on a pooled basis, which we do not consider is feasible. Furthermore, this approach would rely heavily on the apportionment of bad debt costs to customer groups. It is not clear to us that Retailers have been able to apportion these costs sufficiently accurately to avoid risks that some customers would bear bad debt costs not arising in their customer group.

We consider further that any potential drawbacks of pooling across all customers, for example concerning the question of any undue cross subsidisation of particular customer segments, would be minimised since the adjustment to REC prices to take effect from April 2022 in respect of bad debt costs will be minor and temporary.

We note that under our approach, Retailers would retain pricing freedom in respect of Customer Group Three (customers with annual consumption exceeding 50Ml). We would expect those Retailers best able to contain bad debt costs to face least pressure to increase prices for this customer segment by the adjustment to be applied to REC price caps, and so retain a competitive advantage that we would expect to see passed through to customers.

Regarding the point that pooling would disadvantage Retailers who primarily serve customers that fall within a single REC defined customer group, we recognise that bad debt costs may to some extent have varied between customer groups, as well as sectors (e.g. hospitality, leisure) and regions (e.g. owing to regional lockdowns) and so may in principle have affected some Retailers more than others. But it is not clear to us, and nor have Retailers put forward strong evidence on this, that such effects systematically and materially disadvantage some Retailers over others. Furthermore it is our policy intent to provide regulatory support at the market level and so protect customers' interests through the minimisation of risks of systemic Retailer failure, rather than to target support to particular Retailers.

3. Timing and next steps

What we said in the July 2021 consultation

Our July 2021 document noted our decision to adjust REC price caps with effect from April 2022, our view that we would need to take a decision on pursuing any 'true up' in the light of more up to date data to be gathered via an October 2021 RFI, and our intention to undertake a full review of REC price caps during 2022 with the aim of any changes taking effect from April 2023. In light of these points, relevant next steps set out in our July 2021 document were:

Next steps	
October 2021	• Retailer RFI, for return November 2021[3].
by December 2021	• Publish planned approach for our wider review of REC price caps • Publish Consultation on adjustment to REC price caps to apply from 1st April 2022, to include our Decision on whether or not to pursue a 'true up'
February 2022	• Publish Decision on adjustment to REC price caps 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'.

Our anticipated timetable in particular sets out our intention to publish our final decision in February 2022 on the adjustments to apply to REC price caps from April 2022 in respect of excess bad debt costs.

Retailer timings for tariff changes

Two Retailers in their responses to the July 2020 document expressed concerns about Ofwat's intention to publish in February 2022 its final decision on adjusted REC price caps to take effect from April 2022. They suggested for example that this left Retailers relatively little time to take the Decision into account and finalise and communicate any relevant price changes to their customers by 1st March 2022, with any price revisions taking effect from 1st April 2022.

We note concerns here. We note that our plan to consult in December 2021 on adjustments to apply to REC price caps from April 2022 should assist Retailers in their tariff planning. Furthermore, in recognition of concerns, we will also endeavour, so far as we are able, to publish our Decision earlier rather than later in February 2022. We note that this may include preferring an earlier rather than later deadline for responses to the anticipated December 2021 consultation.

[3] Note that since we have decided to pool excess bad debt costs across all customer groups, our October 2021 RFI will not seek detailed data on bad debt costs by customer group.

Next steps

Concurrently with publication of this October 2021 update, we are writing to Retailers with a request for information (RFI). Among other things, this will seek updated data on outturn bad debt costs to March 2021 as well as available data to end September 2021.

In line with the decisions set out in our July 2021 document, noting that we remain to make decisions concerning any 'true up', and taking into account concerns expressed regarding the tariff setting cycle, our intended next steps remain as set out in the table above. We will also endeavour, so far as we are able, to publish our Decision earlier rather than later in February 2022.

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

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