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A SCOTTISH WATER COMPANY

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

12th January 2022

Dear Georgina,

COVID Customer Bad Debt: December Consultation on Adjustment to the REC Price Caps from April 2022

I write in response to Ofwat's December bad debt consultation, regarding the proposed adjustment to the REC price caps to apply from April 2022.

Responses to the individual questions posed are attached, together with the detailed supporting evidence. However, we are extremely concerned that the methodology set out in the consultation paper and Ofwat's calculation of the REC adjustment are inconsistent with the approach established in previous decision papers. This proposal would allow retailers to recover less than half of what we have been led to expect and is a significant departure from the principles established over the period since April 2020.

In the very earliest consultation papers, Ofwat provided retailers with an assurance that they would not have to carry all of the COVID bad debt, and committed to providing support for a proportion of 'excess' bad debt above a 2% threshold. In the July 2021 decision document, it was confirmed that:

- retailers' bad debt provisions for the years ended 31 March 2020 and 2021 would be used as the basis of the calculation of 'excess' bad debt costs;
- bad debt levels had exceeded the 2% threshold in both 2019/20 and 2020/21; and
- retailers would only be able to recover 75% of the bad debt costs above 2%.

On this basis, and using the latest RFI figures provided in the December consultation paper, 75% of the excess bad debt that has been incurred over the two years affected by COVID, and which should be recoverable through the REC uplift amounts to **just over £31m** (details of the calculation are set out in response to Q1 in the attachment). However, Ofwat's calculation of the REC uplift includes only the (less significant) excess bad debt costs incurred in 2020/21, and excludes the costs incurred in 2019/20. This results in a recoverable cost of **only £14.3m**.

We raised a clarification query with Ofwat as soon as we identified this issue, in the hope that there had been an error in the calculation, but the response issued by Ofwat on 21st December suggests that this is not the case. Given the materiality of the change, the late stage at which it was introduced following months of consultation and dialogue, and the fact that it appears to have taken all retailers by surprise, we would strongly advocate the need for Ofwat to provide further clarity on the rationale for the change.

Implications for the Future of the NHH Market

The future of the NHH market feels very uncertain at the moment. As we go into the REC Review process, which will be critical to restoring investor confidence in the market, this bad debt decision paper has the potential to undermine confidence in the transparency of the regulatory decision-making process.

Based on the information in the consultation, retailers' bad debt for the period 2019/20 and 2020/21 is £137m; £89m above the 'normal' 1% level. Under Ofwat's December proposal, retailers would be allowed to recover only £14.3m of that. In a market that has been loss-making for most retailers since the outset, it is not clear how Ofwat envisages that retailers will meet the shortfall. Whilst the aim of the COVID bad debt support was to help avoid the risk to customers of systemic retailer failure, this decision has the potential to do the opposite.

As we have said in previous responses, it is particularly frustrating that the treatment of retailers during this process has been at odds with the treatment of the wholesalers. For the most part retailers have offered extensive support to their customers during the pandemic, and, despite customer non-payment, we have continued to pay wholesale charges in full. Following an extensive process of data collection and multiple consultations, Ofwat has now proposed that retailers be allowed a price increase of just 0.31% to cover COVID bad debt costs. By stark contrast, the monopoly wholesalers were allowed to recover all of the lost revenue experienced as a result of COVID, immediately increasing their charges from April 2021, with no suggestion of any sharing mechanism, or delayed recovery to minimise the impact on customers. Wholesale prices are continuing to rise for a second year, with further increases in 2022/23 of up to 10 or 11% in some regions.

With the reintroduction of restrictions on some businesses as a result of the Omicron variant, and employees continuing to work from home, the impact of COVID on our customers, and on retailer revenues is not over yet. We need an assurance from Ofwat that during the REC Review process, retailers will be treated fairly, that the real costs of operating in the NHH market will be recognised and recoverable, and that efficient retailers will be able to earn a reasonable return commensurate with the risks of the market, including any ongoing impact from COVID.

We are seeking an urgent meeting with Ofwat through the UKWRC, to discuss the issues raised in this letter. In the meantime, if you have any queries about the above, or the responses to the specific questions attached, please don't hesitate to contact me.

Yours sincerely

[redacted]

Rosalind Carey
Regulation and Strategy Advisor

COVID Customer Bad Debt
December 2021 Consultation on Adjustment to the REC Price Caps from April 2022

Business Stream Response

Consultation Question 1 – Do you agree with our methodology (as set out in Annex A3 and in the accompanying Excel spreadsheet model) for calculating the temporary uplift to REC price caps to apply from April 2022?

No, we do not agree. The methodology set out in the consultation paper is not consistent with the decisions made in previous Ofwat documents, and the expectations set about retailers' ability to recover 75% of 'excess' bad debt costs. This latest proposal would allow retailers to recover less than half of what we have been led to expect and is a significant departure from the principles established over the period since April 2020.

From the very earliest bad debt consultation papers, Ofwat provided retailers with an assurance that they would not have to carry all of the COVID bad debt, and committed to providing support to retailers for 'excess' bad debt above a 2% threshold:

> *"We will monitor the level of additional COVID related bad debt….and if it looks like bad debt across the market is likely to exceed the 2% threshold, we will provide regulatory protection for a proportion of this exposure"*[1]

In the July 2021 decision document, it was confirmed that retailers' bad debt provisions would be used as the basis of the calculation of 'excess' bad debt costs.

> *"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"*[2]

It was also confirmed in the July document that bad debt levels had exceeded the 2% threshold in both 2019/20 and 2020/21, and that retailers would be able to recover 75% of the bad debt costs above 2%.

On the basis of these principles, and using the latest RFI figures provided in the December consultation paper, the amount of excess bad debt that has been incurred (to date) and should be recoverable through the REC uplift is just over £31m, or 0.65% as shown in the table below.

[1] Executive Summary, Proposals to Address Liquidity Challenges and Increases in Bad Debt, April 2020.
[2] Executive Summary, Decision 4, Business Retail Market: Customer Bad Debt – Decision and Consultation, July 2021.

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Calculation of Market-wide, Recoverable Excess Bad Debt Costs

	2019/20	2020/21	Total over 2 years
Outturn mkt revenue	£2,565,000,000	£2,194,000,000	£4,759,000,000
% bad debt incurred	3.35%	2.31%	2.87%
Value of bad debt incurred	£85,927,500	£50,681,400	£136,608,900
'Excess' bad debt (i.e. over 2%)	1.35%	0.31%	0.87%
Value of 'excess' bad debt	£34,627,500	£6,801,400	£41,428,900
Of which 75% recoverable	£25,970,625	£5,101,050	**£31,071,675**
% recoverable	1.01%	0.23%	**0.65%**

However, Ofwat's December calculation of the REC uplift includes only the excess bad debt costs incurred in 2020/21, and excludes the costs incurred in 2019/20, resulting in a recoverable cost of **only £14.3m**.

We raised a clarification query with Ofwat as soon as we identified this issue, in the hope that there had been an error in the calculation, but the response issued by Ofwat on 21st December suggests that this is not the case. Given the materiality of the change, the late stage at which it was introduced following months of consultation and dialogue, and the fact that it appears to have taken all retailers by surprise, we would strongly advocate the need for Ofwat to provide further clarity on the rationale for the change.

Consultation question 2 – Do you agree that it is reasonable, for the purposes of revising regulatory protections in respect of excess customer bad debt costs arising following the Covid-19 pandemic, to approximate efficient financing costs for Retailers at 3.5%? Please provide evidence or supporting materials for your views.

As illustrated in our last RFI submission, 3.5% is broadly aligned to the cost of the financing facilities that we put in place, which would have been required to fund our increase in working capital resulting from COVID, had we not been able to draw on cash reserves. We cannot comment on the cost of other retailers' financing arrangements, all of which are likely to be different. However, 3.5% is considerably below the rate of ~6% that Ofwat allowed the wholesalers to charge retailers for temporary liquidity support during summer 2020 (which is also considerably above the wholesalers' cost of capital). Will retailers be refunded the difference?

However, our primary concern is that the methodology proposed does not include the cost of bad debt provided for in 2019/20, and hence it also fails to include the cost of financing that proportion of the excess bad debt.

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Consultation question 3 – Do you have views concerning forecast business retail market revenue out to 2023-24 for the purposes of calculating the proposed adjustment to REC price caps to take effect from April 2022?

We are not anticipating significant growth in customer consumption in 2022/23 and 2023/24. You will see from the data in our latest RFI submission, that the projected growth in our revenues for the next two years comes largely from the acquisition of more customers, rather than an increase in revenue (or volume) per customer.

On this basis, the projected increase in total market revenue in Ofwat's calculation may be too high. This would almost certainly be the case if Ofwat's projections are based on the sum of retailers' forecast revenues from the RFI submission, as it seems very likely that retailers' business plans will all be underpinned by ambitions to expand their customer bases and increase revenues, but in practice not everyone will be able to achieve them.

Consultation Question 4 – Do you agree with our proposals to temporarily increase REC price caps by 0.31% with effect from April 2022?

For the reasons stated in response to Q1 above, we do not agree with the proposed uplift of 0.31%, and believe that it should be 0.65% (as shown above), plus financing costs.

We agree that the correct uplift should be applied from April 2022, and would request that a resolution to the issue raised above is sought as a matter of urgency, to allow 2022/23 prices to be finalised and published.

Consultation Question 5 – Do you agree that the proposed amendments to the Retail Exit Code as set out in Annex A4 are correct in terms of implementing the proposed adjustment to REC price caps we have set out? If not, please specify why and how you think these should be adjusted.

Again, for the reasons stated in response to Q1 above, we do not agree with the proposed uplift of 0.31%, and believe that it should be 0.65%, plus financing costs.

If the correct percentage uplift is applied to the net and gross margins, we agree that it would deliver the required uplift in revenue.

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