Customer Bad Debt December 2021 Decision and Consultation

Response of Castle Water Limited

Introduction

This is the response of Castle Water Limited ("**Castle**", "**we**") to the above Decision and Consultation document issued by Ofwat on 7 December 2021.

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?

We would note two specific provisos that combine to underestimate by c. 50% the true level of bad debt that ought to appear in the outputs of the model.

These relate to simple mathematical inconsistencies that do not properly reflect the incidence of bad debt provisioning.

Averaging bad debt provisioning over two years

Ofwat accepts, correctly, that Retailers' practices in provisioning for and writing off bad debt may legitimately differ considerably, both as between them and from year to year:

> '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.'[1] *[Emphasis added]*

In practice companies will tend to make larger provisions for Covid-19 in one or another year, but not necessarily both. Some will make early provision that they unwind in later years (for example, a company may make a large provision for Covid-19 in one year because they can treat this as an 'exceptional' item which may be excluded from the calculation of their financing covenants; others will make provision later as required by unfolding events).

The actual incidence of actual bad debt provisioning in 2019/20 therefore means that averaging the bad debt over a two year period to arrive at 2.87% has the effect of dampening this percentage and hence the overall excess bad debt cost.

Applying the two year weighted average to only one year's revenue

Applying the resulting weighted average bad debt to only one year's revenue, in particular to the lower 2020/21 revenue, further dampens the overall excess bad debt cost.

Mathematical logic would suggest that 2019/20 provisioning should be applied to 2019/20 revenue and 2020/21 provisioning to 2020/21 revenue; or apply total provisioning to total revenue over both years together, not an artificial hybrid of the two.

As shown in the attached spreadsheet, and extracted below, these factors together more than halve the true quantum of excess bad debt:

[1] July 2021 Consultation

	Revenue	bad debt %	% to be borne by retailer	proportion to pass to customers		Excess bad debt costs			
ebpc	2,194,000,000	2.87%	2%	0.75		**14,315,850**			ofwat modelled
ebpc	2,586,315,789	3.35%	2%	0.75		**26,186,447**			% rate reported for each yr
ebpc	2,194,000,000	2.31%	2%	0.75		**5,101,050**			% rate reported for each yr

This under-recovery is further exacerbated by the decision to attenuate recovery over two years (with a financing cost that grossly understates the true cost – see below).

Note that we have not attempted to attribute bad debt provisions as a proportion of the corresponding revenue in part of 2019/20 (i.e. from October 2019). This is because it is meaningless in accounting practice terms. When deciding what provision to make at year-end, a company does not attribute provision for an event (e.g. Covid-19) to a particular in-year period as it is applied to revenue for the year as a whole.

In sum, we consider that the above errors have the effect of vitiating Ofwat's proposed decision, and require correction.

In terms of process, we note the 'clarification' of Ofwat's approach in its email of 21 December 2021 to Retailers, based on parts of statements in Ofwat's July and December 2021 Decision and Consultation documents referring to the elements of the methodology discussed above. These documents were, however, preceded by and / or contained clear indications that the recovery of bad debt would relate to its incidence in each of the two years in question. They did not make it explicit that this would not be the basis now proposed. Indeed, it is evident that a different inference was to be drawn from statements such as (for example):

(i) 'a Retailer already carrying industry average bad debt of 1% should expect to absorb bad debt costs up to 2% of *annual* turnover'.[2]

(ii) 'this work will include the definition and measurement of bad debt costs, the extent to which these have arisen *in 2018/19 and subsequently on a consistent basis*'.

'If the time period impacted by Covid-19 measures extends to more than one financial year then *we would expect the basis of the calculation to be applied to each financial year*.'[3]

(iii) 'Retailers [will] submit cost data and information … *for financial years 2018/19, 2019/20 and 2020/21*. [.....] 'Retailers are expected to bear, at an industry-wide basis, up to 2% bad debt costs and a portion of any market-wide excess bad debt costs incurred *beyond this level*.' [4]

(iv) 'We note that on an industry wide basis … bad debt costs were 2.9% of revenue *in 2019/20*'.

[2] April 2020 Decision Document

[3] Ibid.

[4] March 2021 Consultation

> 'May 2021 reported outturn bad debt costs for 2020/21 have fallen to 2.1% of revenue *for the period*'.'
>
> 'We have decided that, in order to facilitate a timely preparation and analysis of the initial adjustment to the 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*.'[5]

In any event, we consider the mathematical inconsistencies noted above are sufficient alone to justify an adjustment to the methodology.

In addition, we note Ofwat's statement that:

> 'An individual Retailer should not be disadvantaged, compared with other Retailers, simply because of inconsistent approaches to measuring and reporting bad debt costs.'[6]

This is precisely what the proposed approach does. To illustrate this we provide in the attached spreadsheet, using the published numbers of each, how these variations in practice would affect four Retailers. This shows the stark differences that arise depending on whether a Retailer had taken the bulk of its Covid-19 provisioning in the first year or adopted a more even distribution.

These numbers are based on the full revenue and provisioning values in the statutory accounts reported to Companies House, so may not match exactly what each has submitted to Ofwat – for example, we do not know what might be apportioned to English or Scottish businesses. But note that two of these have - as noted above - specifically included 'exceptionals' in their accounts for 2019/20, all or almost all attributed to Covid-19.

We therefore ask that Ofwat explain how they have reached the 2.87% figure as no underlying calculations are provided – e.g. is it the charge to the P&L account in each of the two years, averaged? In the context of Retailers understanding that they have not been unfairly disadvantaged, Ofwat should show its calculations, on a redacted basis (i.e. Company A etc.), so that the full detail of the calculation is transparent.

Finally, in looking only at provisions made in 2019/20 and 2020/21 and basing recovery only on the latter, the methodology (i) assumes that the effects of the pandemic are largely confined to 2020/21; and (ii) takes no explicit account of the time lags in the emergence of the causes of bad debt, namely: insolvency; customers gone away; and litigation – all of which can take many months or even years to crystallise. *Absent* a true up that takes these into account, or a method of estimating their effects, the methodology has an inbuilt bias to under-recovery.

We therefore welcome Ofwat's statement that:

> 'Noting that Retailers will in due course provide audited accounts and other operating cost data, where we find that any such revisions at an industry level are material, we remain open to the idea of revisiting or revising any adjustments to the REC price caps that we may have made in respect of customer bad debt costs.'[7]

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[5] July 2021 Decision and consultation
[6] Ibid.

[7] December 2021 consultation

<u>Consultation question 2 – Do you agree that 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.</u>

Throughout the chain of Ofwat documents on the subject, starting with the April 2020 Decision Document, Ofwat rightly states 'we believe it is in customers' interests to mitigate the risks of systemic Retailer failure during the current crisis'.

The methodology that Ofwat has used to determine efficient financing costs does not further that end; rather the opposite.

First, no underlying data or evidence is adduced to support the choice of 3.5%. The statements that 'the *majority* of retailers by market revenues have been able to secure funding at competitive rates' and that 'retailers where they have reported debt finance costs have *often* reported paying LIBOR or BoE base rate plus up to around 3.5%" [emphases added] are neither transparent nor borne out by Ofwat's limited analysis.

Ofwat appears to be benchmarking the efficient cost of finance as a premium to the cost of financing a wholesaler. Even on that (incorrect) basis, it is below the 5.98% applied to Retailers who opted into the deferred wholesale charge scheme.

Given the nature of the retail water activities and the losses being made elsewhere in the utility sector, this figure can only be achieved by skewing it towards vertically integrated companies benefiting from a related regulated network or from other benefits of membership of a corporate group such as parent company guarantees. Setting an artificially low cost of capital by reference to network effects and vertical integration encourages excessive debt and fragile capital structures, increasing risk for customers.

Second, Ofwat should not assume that 'efficient financing' will continue to be made available at low cost during a global emergency. In respect of debt financing, where banks are considering making loans beyond the immediate term they look at the forward outlook overall. Any Retailer that has current experience of loan financing will confirm that the cost of this is already rising in the market and is likely to rise further as interest rates are increased.

In this context account also needs to be taken of the limits on companies' capacity to service debt. In a sector marked by negative margins and losses, increasing debt beyond this capacity is possible neither in practical terms nor without increasing systemic risk.

Third, and consistent with the above, Retailers' accounts do not support the 3.5% benchmark.

We have submitted our financing arrangements to Ofwat, along with our view that the cost of utility equity funding for bad debt is c. 20-30%. Together with Castle, the great majority of the market is accounted for by Water Plus, Scottish Water Business Stream, and Wave. Their accounts show that, even given their affiliation with network businesses:

- Water Plus note £65m of shareholder loans replaced with £65m of equity and £70m of bank funding - all attributed to Covid-19.

- Business Stream note an additional £10m of equity investment as part of a package of up to £59m of new funding.

- Wave note a £10m equity injection, along with £15m CLBILS. While the CLBILS loan is detailed at 1.46% the accounts specifically note that to the extent any covenants are breached there is a requirement for a debt for equity swap to be made, effectively meaning that the rate is supported by a shareholder guarantee.

In sum, all the large retailers including Castle have had to resort to some form of equity funding at a cost which cannot be remotely close to 3.5%.

Further, Ofwat cite in support of this benchmark that a 'net margin' is somehow equated to a cost of financing:

> 'Furthermore, we note that REC price caps currently applying to Retailers were set on the basis of a market wide 2.5% net margin. In line with our reasoning for liquidity support, we consider applying a further 1% uplift to give 3.5% gives a reasonable retailer efficient financing cost benchmark.'

This purely hypothetical net margin ignores the margins that are actually achieved in practice. It therefore does not provide a financing cost benchmark in a sector with negative average margins.

Given the above, it is notable that Ofwat appears not to have used the benefit of an independent specialist to review the cost of capital. We consider that, given the obvious bias and flimsiness of its analysis and the importance of its decision, Ofwat should expose the reasonableness of its proposed decision to such external scrutiny and take the findings into account.

Together with the mathematical errors noted above, we find Ofwat's current approach wrong from a factual and process point of view, and that it demands reconsideration.

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?

Ofwat notes that 'over optimistic' assumptions about revenues are likely to result in under-recovery of bad debt costs. We consider the forecasts adopted by Ofwat to be over-optimistic.

The principal assumption relates to the point at which revenues return to pre-pandemic levels. This appears to rest largely on:

- Retailers' views, which are described only 'in aggregate' – that is, with no indication as to how they have been 'aggregated' but suggesting a return to pre-pandemic levels in 2022/23.

- Retailer revenues in H1 2020/21 (alone) increasing faster than wholesaler charge revenue, though this is only 'indicative' and reflects other factors.

- The OBR's forecast of GDP returning to pre-pandemic levels around the turn of 2022. If this were so, revenues would lag this by some months.

Unfortunately, setting side their intrinsic weaknesses, all of these indications that a return to pre-pandemic levels might take place in the suggested timescales pre-dated the then imminent arrival of Omicron and its associated restrictions (Ofwat's document was issued only nine working days after the appearance of the first two cases of the variant in the UK). These restrictions are both Government-invoked (e.g. Working from Home, and mask-wearing in indoor settings that has decimated footfall in shopping, entertainment and hospitality venues), and enhanced practical restraints deriving from public caution.

The future course of the pandemic and of these and any further restrictions is of course unpredictable, but the Working from Home requirement announced by HM Government in December 2021 has already reversed the growth in consumption. Settlement data will increasingly show this, but with a lag due to problems taking meter readings while this requirement is in place. As a business, we were forecasting a return to 95% of pre-pandemic levels of consumption by end 2021/22 but have already revised this to 80%. Ofwat should also adjust its expectations downwards in the light of this unavoidably unpredicted development.

Further, as noted under Question 1 above, consideration of the likelihood of under-recovery of bad debt does not take account - either in relation to the estimation of bad debt (see above) or the recovery of revenue - of the following:

- Insolvency – that companies typically trade for an extended period after ceasing to pay utility bills is evident from the Statements of Affairs provided by administrators / liquidators, where it is common to see debts of over 12 months.

- Gone away – when customers simply leave their premises without informing utility suppliers, it can take an extended period to identify that premises are vacant. This is particularly the case with mixed-use and unmetered / assessed charges, where volumetric data cannot indicate vacancy, and will be aggravated by Working from Home requirements. We can recoup debt only from occupied premises.

- Litigation – it is now taking c. 18-24 months to receive judgement in legal cases for debt recovery, and customers who have been failing to pay suppliers may defer a declaration of insolvency while such cases are ongoing.

These factors could well have an effect as great as, or greater than, they have so far had as a result of the previous waves of the pandemic: the effect of those previous waves, and the withdrawal of Government support for business, is still working through; and the Omicron effect continues to grow exponentially, with (so far) no equivalent Government support measures.

Ofwat should therefore revise its forecasts of retail revenue in light of current developments.

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

We agree with the basic proposition of temporarily increasing the REC price caps from April 2022 to provide for recovery of bad debt arising in respect of 2019/20 and 2020/21.

For the reasons given above, Ofwat's methodology for arriving at the 0.31% uplift should be revised to calculate the quantum of bad debt to be recovered in each of the two years, as shown under Question 1, and to sum these numbers to arrive at a revised uplift of approximately double the quantum proposed. This is the main driver of the quantum, and the most obviously wrong element of the methodology.

The associated assumptions on cost of capital and forecasts of revenue are, however, important and should also be revisited.

As to the duration of the temporary uplift, if as we believe the effects of the latest developments in the pandemic and the resulting estimates of retailer bad debt change materially, Ofwat ought to consider extending the period in respect of which the recovery arrangement applies, if necessary

with a true up mechanism, in line with Ofwat's commitment to an allowed price increase under the REC 'enduring for at least two years'.[8]

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.

It follows from the above that the uplift in respect of each Wholesale area and Customer Group should be adjusted accordingly.

Castle Water Limited

11 January 2022.

[8] March 2021 Consultation