Pennon Water Services
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Ofwat
Centre City Tower,
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12 January 2022

By email: [redacted]

Dear Colleagues

BUSINESS RETAIL MARKET: CUSTOMER BAD DEBT – CONSULTATION ON ADJUSTMENT TO REC PRICE CAPS FROM APRIL 2022

Thank you for the opportunity to comment on Ofwat's decision and consultation on customer bad debt in the business retail market. We are supportive of Ofwats intentions to provide a mechanism by which Retailers can recover bad debts due to the impact of Covid whilst offering a level of protection to customers.

As noted in previous correspondence, the impacts of Covid on our customers continue and the risk of bad debt which is valued at the low point of consumption (in 20/21) will be materially higher than Ofwat is recognising through this consultation process.

Therefore, on balance, we are disappointed by the conclusions reached by Ofwat and consider that the likely, future, financial benefits are far below expectation.

Our responses to the consultation questions can be found in Appendix one attached. I hope that you find these comments helpful. If you have any questions, please do not hesitate to contact me.

Yours sincerely

[redacted]

Sally Mills
Chief Executive Officer
Pennon Water Services

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APPENDIX 1

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 are unable to fully understand the methodology because the model runs a macro calculation to draw a conclusion to which we do not have visibility of the inputs or calculations. We also do not have access to the calculations that result in the 2.87% threshold rate which is the primary driver of the bad debt recovery.

The key observations regarding the methodology include:

Deemed contract tariffs vs the overall market
PWS understands that c 43% of the volume of the water retail market is priced at deemed contract tariffs, with the remainder on negotiated contracts. Therefore, the recovery of the bad debt calculation needs to consider this, or we anticipate under recovery of the bad debt cost in the market as we may not be able to recover these costs from fixed priced negotiated contracts.

There is no clear assumption as to the level that deemed contract business will decrease where customers convert to negotiated contracts over the following two years.

Efficient Financing Costs
With reference to the Ofwat email, dated 21 December 2021, from Shaun Kent which refers the retailers to the July 2021 RFI:

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

It is not clear in the Excel model how estimated efficient financing costs are **added** back in the model as set out in Annex A3. There doesn't appear to be a separate calculation adding estimated financing costs.

The application of the discount rate to reduce the bad debt recovery value, applying the efficient financing discount rate does not compensate Retailers for the support we have provided our customers, in fact in absolute values it reduces the benefit to Retailers.

Estimated Benefit to PWS
Overall PWS represents approximately 7% of the market (in revenue terms). Therefore, of the recovery of c £14.3m, our recovery of bad debt over two years should be c. £1.0m or £0.5m per year (7% x £14.3m). However initial calculations suggest our pricing benefit will be c £0.3m annually based on our tariff modelling for financial year 2022/23.

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.

We agree that long term cost of debt is in the region of 3.5%. We do not agree with the proposals and application of financing costs is relevant in the context that it is applied to the model. A financial risk that materialised between April 20 and March 21 is fixed in value, the quantum of the risk does not inflate or deflate with the passage of time.

Generally, we had expected the application of efficient financing to help Retailers recover the interest cost of aged bad debt we incurred whilst supporting our customers during the pandemic. This has not happened, hence our disappointment with the consultation decisions.

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? Business retail market: Customer bad debt Consultation on adjustment to REC price caps from April 2022

- The forecast business retail market overlooks what percentage of the market will continue on deemed contracts or Retail Exit Code (REC) tariffs. Please clarify whether it is only the size of the REC market that is relevant when estimating the recoverability by Retailers?
- The assumption that the market will recover back to pre-covid levels by year end March 2024 seems reasonable
- Broadly the market will be flat or grow up to 4% capturing the full effects of recovery to pre-COVID volumes
- We note the pressure to drive efficiency and volume reduction in the market is excluded. If this were to arise this may result in overestimated recovery of bad debt to REC customers.
- The assumption of inflation remaining at 3.8% for the next two years might be on the high side but can be confirmed once final tariffs are published in late January 2022.

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 your proposals to temporarily increase REC price caps, but we do not agree with the proposed uplift of 0.31%, noting the points raised above, we consider it to be too low.

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.

We do agree with the proposed method of amendment to the Retail Exit Code as set out in A4 but again for the reasons noted we do not agree with the proposed uplift of 0.31%