

By email to: [REDACTED]

12<sup>th</sup> January 2022

Dear Sir/Madam,

## Customer Bad Debt December 2021 Decision and Consultation

Thank you for providing us with an opportunity to respond to the latest consultation on customer bad debt in the business retail market. We are pleased to Ofwat's intention to implement an uplift to the Retail Exit Code (REC) price caps, as we believe this is the quickest way to help reimburse retailers and provide the necessary protections to ensure the health of the market as a whole.

We do, however, have serious concerns about the assumptions used to generate the proposed uplift to the REC and believe the number of 0.31% itself to be a material understatement of the uplift to revenues required to adequately reimburse water retailers to the level previously expressed by Ofwat (i.e. for 75% of excess bad debts incurred above the 2% threshold of revenue during the pandemic).

Our concerns fall into four categories and are addressed separately in each response in the appendix below. These are: the revenue considered (Q1), the efficient finance costs (Q2), forecast revenue (Q3) and the application of the 0.31% to the price control (Q4). There are clearly a range of possible estimates and assumptions that could be applied to these areas so for each area we have sought to explain why the assumption currently proposed represents a low point, suggested a sensible range of options and proposed a midpoint. Using these midpoints, we propose a revised REC uplift at the end of this document of 0.83%.

We appreciate Ofwat's support in addressing the issue of bad debt caused by the Covid-19 pandemic and hope that this information will be useful in helping Ofwat achieve its aims of better market stability. In order to address the true impact on the market, retailers and most importantly to protect customers, it is imperative that the support provided to the market is effective and impactful. We remain committed to supporting the viability of the NHH market and therefore provide the enclosed comments in good faith to help achieve this objective. If there is anything further that we can do to help inform and support Ofwat regarding market issues caused by the pandemic, please do not hesitate to contact us.

Yours sincerely,

[REDACTED]  
Financial Controller  
[REDACTED]

## Appendix: Consultation Questions

### 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 agree with the mechanics of the methodology, and believe the methodology has the potential to calculate an appropriate temporary uplift to the REC in relation to the initial impact of the on-going pandemic. We also note that bad debt will need to be considered as part of the enduring REC review. However, we disagree with some of the assumptions and inputs used in the proposed methodology as laid out in the consultation. In our response to this question, we look at the applicable revenue that the excess bad debt rate is applied to in order to calculate the retailer portion of excess bad debt costs (lines 10 – 17 of the Calculations sheet of the excel model accompanying the consultation – “the Model”). In subsequent questions we look at the other assumptions.

The model looks only at revenue in the 2021 year, which is the lowest year for revenue in real terms as consumption was so heavily impacted by the pandemic. As noted in your requests for information from retailers, most of the bad debt arose in the 2020 year when revenues were higher. It is bills that cover consumption from before the pandemic arose, as well as those from during the pandemic that will turn into bad debt. As the impact of the pandemic in the 2020 and 2021 years both had higher than anticipated bad debt losses, the problem of excess bad debt will only have been addressed if the average bad debt rate from both years is applied to the revenue from both years.

The amount of bad debt to be recovered per the Model is £14.3m based on 0.87% of revenue in the 2021 year but would be £16.9m for the 2020 year (when adjusted to 2021 values) or £31.2m if both years were considered. This would increase the REC uplift to 0.37% and 0.68% respectively. Factually, the 2.87% observed bad debt rate, is the percentage of 2020 and 2021 's revenue that either has, or is predicted to, become bad debt. Failing to account for the bad debt arising in the 2020 more than halves the effective recovery that retailers will experience and will likely prevent the proposed uplift from achieving the stated aim to protect customers' interests in the longer term by mitigating the related risk of systemic Retailer failure.

We acknowledge that not all revenue of the 2020 will have been affected by covid, but the 2.87% number quoted by Ofwat is an average bad debt rate experienced against revenue for that year. If a smaller subset of revenue is used, then a larger bad debt uplift % would need to be applied. E.g., the table below shows how bad debt might have arisen in 2020. Before the pandemic hit, bad debt rates are much lower, then at the point the pandemic hits, the bad debt rate increases rapidly. The outturn bad debt charge as a percentage of revenue for the year might have been 2.87%, but the actual bad debt rate experienced specifically in the months affected by the pandemic was much higher. We cannot easily see the individual month on month percentages. Therefore, to adequately reimburse the excess bad debt incurred by retailers during the pandemic, the average bad debt charge % for both years (2020 and 2021) must be applied to the total revenue for both years.

	Q1	Q2	Q3	Q4	Total
Revenue (£m)	641.3	641.3	641.3	641.3	<b>2,565.0</b>
Bad debt rate %	1.00%	1.00%	1.00%	8.48%	<b>2.87%</b>
Bad debt charge (£m)	6.4	6.4	6.4	54.4	<b>73.6</b>

**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.**

It is reasonable to approximate efficient financing costs for retailers, but we do not agree that 3.5% is an appropriate efficient interest cost for financing bad debt. The 3.5% rate, by Ofwat's own acknowledgement, is less than the mid-point of borrowings for retailers as it ignores the base rate that is added on to the actual interest charges. The actual mid-point for debt, as noted in Ofwat's paper is 3.5% plus a base rate, which has typically been 0.1% during the pandemic, meaning the efficient borrowing cost is likely to be 3.6%.

We also do not agree that the estimation of an efficient borrowing rate represents the rate at which a retailer could finance bad debt. Many retailers had to finance their bad debt by deferring wholesale charges at 5.98% being the rate charged by wholesalers applying the wholesale charge deferral scheme. While wholesalers were free to charge lower interest, many if not all chose to apply the full 5.98% for the duration of the scheme.

Once the deferred wholesale charges scheme finished, retailers had to seek new sources of funding to make up their funding shortfall caused by bad debt. Bad debt by itself is not an asset that can be financed under normal circumstances because you cannot use non-performing debt as security for borrowing. An asset (customer debt) that will not be paid (bad debt) cannot be financed as there will be no cash flow (in the form of payment of the debt) against which to secure the loan. Therefore, retailers are faced with either – financing bad debt through borrowings where the credit quality of the aggregate debt book being financed has decreased, leading to a higher rate being paid across the whole borrowing book, or financing the bad debt by using retained earnings of the business, which are typically much more costly than debt finance (cost of equity instead of cost of debt).

This reduction in the creditworthiness of retailer debt books due to the levels of bad debt seen during the pandemic is being baked into the rates being charged by lenders such that retailers will potentially be forced to pay debt at an average higher effective interest rate for a long time to come as they must fix in the rates on offer when debt is refinanced. Therefore, the following scenarios are proposed:

Scenario	Rate	Assessment
Base case	3.50%	Less than efficient retailer cost of debt (as ignores the base rate) and fails to account for the fact that bad debts cannot be financed with debt.
Blended rate	4.74%	Midpoint between 3.5% and 5.98%. A simplification of the fact that retailers financed their bad debts at 5.98% for a period of time, then may have been able to use available facilities at 3.5% to finance bad debts for a while.
Deferred wholesale charges	5.98%	The rate paid by retailers to finance the extra working capital charges (some of which became bad debt) during the pandemic.
Cost of equity	10.00%	Estimation of efficient retailer cost of equity. Acknowledging that bad debts aren't fundable with debt and must be funded by future profits of the business.

### **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?**

It is our view that the revenue growth used in your model is overstated: 10.5% per year or 8.5% per customer over three years. It is likely that the aggregate of individual retailers' forecasts will include estimations of increasing market share, which if true, would necessitate a reduction in market share for another retailer. We set out below three main reasons why we believe market revenue will be less than forecasted in the consultation and provide a best estimate of outcomes:

- 1. Move from non-household to household as a result of changing business practices brought about by the pandemic*

External factors play a part in reducing revenue. It is becoming increasingly apparent that some water consumption may have moved permanently from non-household to household with the increased prevalence of working from home, even when lockdowns have lifted. This would prevent consumption levels from reaching "pre-pandemic" levels in the near future in real terms unless there is a significant expansion in UK businesses.

- 2. Retailers are embarking on initiatives to encourage water efficiency, potentially reducing overall market consumption.*

Coupled with this, retailers are typically embarking on water saving initiatives that will further bring down consumption across the non-household market in coming years.

- 3. Customer switching reduces the size of the market*

Customer switches between retailers, even if they preserve market share, reduces the total revenue from customers due to customer savings taking place once contracted.

On this basis, we believe that the revenue growth numbers should be rounded downward to be no more than 95% of 2020's revenue ("pre-covid" revenue less a 5% shift to household). Any nominal increase from this point can be attributed to inflation.

This would uplift the REC adjustment from 0.31% to 0.32%.

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

Addressing this question in two parts, we are grateful and pleased to see the retailer support being implemented with effect from April 2022. However, we do not agree with the uplift to REC price caps being 0.31%, for the reasons described above and because applying the 0.31% calculated in the model to the price controls does not equate to increasing revenue by 0.31%. We demonstrate this below.

#### **Application of markup to revenue**

The proposed model calculates a percentage uplift to revenue that will, on a present value basis, lead to the opportunity to generate additional revenue to the same value as the amount of excess bad debt charges that are eligible to be recovered. This step of the model is valid, but

an error arises when in section 3.6 of the consultation, it is proposed to add the percent uplift to revenue onto the margins and mark-ups used in the customer group A and B price control calculations. An uplift to revenue in the form of a mark-up percentage is not the same as either applying an uplift to a margin (as in Customer group A) or as applying the same percentage uplift to a mark-up on wholesale charges. Using the numbers from appendix 2 of the consultations we see the following:

For a Group 1 customer:

Component	Value
Wholesale charge (£)	300.00
Retail charge	28.75
Margin (without BDR)	3.55%
Margin (with BDR)	3.86%

Where:  $Revenue = (Wholesale\ charge + Retail\ charge) / (1 - Margin)$  the outcomes are:

Scenario	Value (£)	Increase
Revenue without BDR	340.85	
Revenue with BDR	341.95	0.3226%

These customers will end up with a revenue increase higher than the intended 0.31%.

For a Group 2 customer:

Component	Value
Wholesale charge (£)	300.00
Markup (without BDR)	8.00%
Markup (with BDR)	8.31%

Where:  $Revenue = Wholesale\ charge \times (1 + Markup)$  outcomes are:

Scenario	Value (£)	Increase
Revenue without BDR	324.00	
Revenue with BDR	324.93	0.2871%

These customers will end up with a revenue increase lower than the intended 0.31%.

Combining the two scenarios, we see that in the above scenario the total increase to revenue across both customers is lower than the 0.31% calculated uplift from the excel model.

Scenario	Value (£)	Increase
Revenue without BDR	664.85	
Revenue with BDR	666.88	<b>0.3053%</b>

The exact blended increase in revenue will differ from retailer to retailer based on their own customer book composition, and actual outcomes may result in immaterial difference, but there are two notable outcomes:

1. You cannot apply a revenue uplift simply to the price controls to achieve the intended outcome. Doing so suppresses the potential recovery; and

2. The uncertain nature of the uplift split across customer groups could lead to unforeseen consequences.

To adjust for this, rather than rewriting the methodology at such short notice, we propose adding another 0.1% onto the REC uplift to mitigate or minimise the impact of this issue.

**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 agree that an adjustment to the REC is a sensible and timely way to start to protect the functioning of the non-household water retail market in the wake of the excess levels of bad debt incurred during the ongoing pandemic. However, for the reasons discussed above we believe that using 0.31% for the uplift significantly underestimates the level of excess bad debt that is to be recovered and therefore, to implement the amendments to the REC as proposed could fail to sufficiently protect the non-household water retail market and therefore the wider water market and its customers.

In each step of the calculation, we note that the minimum point on the range of viable options has been chosen. When combined, these steps lead to a materially understated value. We address each variable below, taking what we believe to be a balanced approach:

Area	Base case	Revised case	Rationale
Applicable Revenue (Q1)	£2,194m	£4,759m	The blended bad debt rate of 2.87% is a blended percentage incurred over two years
Efficient finance costs (Q2)	3.5%	5.98%	Bad debt cannot be financed at 3.5%
Forecast revenue (Q3)	£2.586m	£2.442m	Revenues unlikely to reach pre-pandemic levels in real terms
Price cap uplift (Q4)	-	+0.1%	Small uplift to counter the margin vs. markup effect

The impact of these items is to:

Item	Base case	Revised case
Real amount of excess bad debt	£14.3m	£31.2m
REC increase amount	0.3101%	0.8334%
Nominal amount to be recovered by retailers	£15.6m	£36.1m

As previously discussed in a letter sent by Water Plus on the 24<sup>th</sup> of December, we would additionally raise the concern that the specific terminology contained within Appendix 4 appears to suggest a change to the practical application of the Retail Exit Code pricing restrictions.

The effective price control within the Retail Market was clearly established at PR16 as an average revenue control per customer group, with retailers retaining the “freedom to set tariffs for its customers provided that it meets the overarching requirements of the price control”. We would appreciate clarification that this remains the appropriate methodology, as some of the

wording contained within Appendix 4 appears to suggest this should be applied as a strict pricing cap at the customer level. As such a change would create significant technical challenges for retailers to deliver as well as a high risk of leading to large price shocks for the customer base, we believe further discussion would be necessary before such an interpretation would be feasible within the marketplace.