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Dear Ofwat

Customer Bad Debt – Consultation on adjustment to Retail Exit Code (REC) price caps from April 2022

The proposals in the consultation (and the subsequent clarification letter from Shaun Kent dated 21 December 2021) do not reflect what had been anticipated by Retailers following previous dialogue with Ofwat. Our understanding from Ofwat is that Retailers would be protected against bad debt costs which exceed a 2% threshold, with the burden of these 'excess' bad debt costs shared between Retailers (25%) and non-household customers (75%). The adjustment would be based on Retailer's accounting data. Wave has been clear that our debt cost has been split across two years (2019/20 and 2020/21) and Ofwat has used an average bad debt cost of 2.87% calculated over the two years. Therefore, it was expected that the uplift would also apply to revenue across the two years. However, the calculation in the consultation only applies the uplift to revenue in 2020/21. Consequently, this only enables recovery of half the excess bad debt costs incurred and is insufficient to protect customers from the systemic risk of Retailer failure. Furthermore, in the light of recent Covid developments, it seems increasingly possible that the pandemic may continue for some years and excess bad debt costs may continue into 2021/22 and potentially longer. Should this be the case then the impact of these proposals is even greater.

Given this apparent fundamental difference in understanding between Ofwat and Retailers, we feel that it is important to be able to discuss this in more detail and agree a way forward. Therefore, we support a meeting between Ofwat and Retailers once Ofwat has had chance to consider and reflect on the consultation responses received.

It should also be noted that Wholesalers are proposing to substantially increase their Wholesale Charges to non-household customers from April 2022, to include recovery of the costs of the impacts of Covid-19 on their businesses. The perception is that this appears inconsistent with Ofwat's proposals for Retailers.

Wave has responded to the questions posed below to set out in more detail our views on Ofwat's proposals to temporarily amend the Retail Exit Code (REC) with effect from April 2022.

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, there is a fundamental flaw with the basis of the calculation because the uplift has only been applied to revenue in 2020/21 i.e. one year not two, and thus halves the benefit expected.

Wave has been clear throughout that our debt cost has been split across two years, with a significant provision taken in 2019/20, then further provisioning made in 2020/21. Ofwat has appropriately assessed the industry cost of debt across both these years as an average of 2.87%, but using the reported costs in the consultation document, the actual costs incurred are as follows:

2019/20 revenue (£2,565k) x 3.35% AND 2020/21 revenue (£2,194k) x 2.31% = £136.6m

Applying the 2% cap and 75/25 sharing methodology would imply recoverable costs as:

(£2,565k x 1.35% + £2,194k x 0.31%) x 0.75 = £31.05m

This approach already gives Retailers a double impact as they are having to absorb the difference between the underlying costs and the 2% threshold for BOTH years rather than treating this as one exceptional event. For an average performer, this means a 1% or £2.2-2.5m increase in costs (being the difference between market average of 1% and the 2% hurdle) for two years rather than one.

Using the average cost of 2.87% in the calculation as per Ofwat's methodology will get to the same answer, but only if you apply the 2.87% to two years' revenue:

(£2,565k+£2,194k) x 0.87% x 0.75 = £31.05m

Instead, Ofwat has taken the 2.87% average cost over the two year period (which is derived from revenues and costs in BOTH years) and applied that to just 2020/21 revenues. This halves the recoverable benefit to Retailers and actually allows recovery of 75% of 0.43%, not 75% of the 0.87% excess. Against an average bad debt cost of 1% pre pandemic, this approach is leaving Retailers to absorb an additional debt cost of 1.56% for two years running. The resulting 2.56% borne does not seem consistent with the principle of 75%/25% sharing between non-household customers and Retailers.

Ofwat acknowledges that "some Retailers chose to make relatively early and heavy provisions in 2019-20 in respect of possible bad debt costs arising following the pandemic." With this in mind, Ofwat is acknowledging that costs incurred in 2019/20 also need to be considered for recovery, so it is not clear why 2019/20 revenues (and therefore bad debt costs) are excluded from the calculation.

Ofwat's approach of choosing "to take a weighted average of reported bad debt cost across the two years ended 31 March 2021 (i.e. 2.87% of turnover) as more properly indicative of the customer bad debt costs arising for 2020-21" would be appropriate if Retailers had taken additional costs in either 2019/20 OR 2020/21, however this is not the case. Many of those that took cost in 2019/21 have demonstrated increased costs in both years which is ignored in the calculation. The fact that the mechanism would require Retailers to bear up to 2% each year should be enough to allay any concerns that Retailers are over-benefitting, but where there is an obvious case that costs have exceeded the 2% in both years, there seems to be no logical answer why the calculations ignore one years' cost.

If the preferred route is to apply the excess average costs across the two years to just one year of forecast revenue, the 0.87% excess should be doubled to 1.74%, before then applying the 75/25 split (reducing to 1.3%) and then splitting across 2 years and discounting (reducing to 0.62% per year).

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.

This seems reasonable, although please note that all bar one Wholesalers charged Wave the maximum fee of 5.98% despite this being set as a ceiling.

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?

With the continuing uncertainty prolonged by the Covid situation, it is not clear if returning to pre-pandemic revenue levels by 2023 is the right assumption. Growth forecasts are changing all the time, such that the forecasts provided by Retailers may already be outdated. Therefore, assumptions need to be tied to the latest economic outlook data.

We also highlight that we understand that there is a general assumption on the Household side that there is a shift of consumption from Non-household to Household that may be permanent as it is associated with the shift to flexible home working. Macro-economic forecasts need to be considered to quantify this impact as the general market commentary is that working habits have permanently shifted from pre-pandemic levels. See link to Office for National Statistics (ONS) research undertaken in June 2021 which indicated that 85% of homeworking adults wanted to use a “hybrid” approach to working in future and 25% of trading businesses stated they intended to use increased homeworking going forward (49% in the Information and Communication industry).
https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/articles/businessandindividualattitudestowardsthefutureofhomeworkinguk/apriltomay2021

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 proposal to increase the REC price caps from April 2022, but we fundamentally disagree that 0.31% is an appropriate amount – see our comments under question 1.

To address this, we propose an increase in the REC price caps by 0.62% with effect from April 2022 to recognise that the impact has been spread over two years.

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.

Yes, subject to our comments under question 1.

Following our comments in our last response on the timing of Ofwat’s decision, we note from the consultation document that Ofwat is proposing to publish its decision in February 2022. To achieve our timescales, we need a decision by Ofwat as early as possible in February so that we have a reasonable amount of time to apply Ofwat’s decisions and obtain Board approval whilst maintaining obligations to customers that they will receive advance notice of price changes. In order to meet the current 30 day requirement for notice, we would need the uplift to be confirmed by mid-February at the latest in order to incorporate into tariffs and secure approval.

The wording in Annex A2 would benefit from further clarification by Ofwat because it could be read and interpreted to mean that the REC restrictions are a strict price cap to be applied at *the individual customer level depending on their customer type*. In practice, this would mean that rather than having the (intended) freedom to calculate a single suite of tariffs following the required calculations at an aggregate level, such calculations would instead be applied at the customer level. The effective price controls were established as an ‘average revenue control’ within specific customer types (aligned to volumetric bandings). Within the methodology of PR16, it clearly states that tariffs should be set such that “default tariffs reflect the maximum allowed revenue per customer type” with further clarification that “within each tariff band, each company will retain the freedom to set tariffs for its customers provided that it meets the overarching requirements of the price control”.

We hope that our response is useful. Do let me know if you would like to discuss further.

Yours faithfully

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[redacted]
Director of Regulation and Compliance