

WHOLESALE-RETAIL CODE CHANGE PROPOSAL/ CHARGING CHANGE PROPOSAL

Change Proposal Reference <i>(To be completed by the Panel Secretary)</i>	CPW086	Version No	1
Type of Change Proposal: <i>(delete as appropriate)</i>	Change Proposal		
Submission Date	9 January 2020		
Title: of Change Proposal/Charging Change Proposal	Unsecured Credit Allowance - Rebalancing		
Summary: of Change Proposal/Charging Change Proposal <i>(40 to 50 Words Maximum)</i>	Amend the Wholesale Contract to increase from 20% to 40% the Unsecured Credit Allowance for Retailers with a Credit Assessment Score of 10. This represents a conservative approach to mitigating, whilst still falling short of compensating for, the current level of unjustified discrimination against independent Retailers and in favour of Wholesalers and Associated Retailers.		
General Details of the Proposer			
Name of Proposer	Christopher Wright		
Capacity (to submit Change Proposals and Charging Change Proposals – on behalf of a Party, as a Panel member, as the customer representative, or the Market Operator or on behalf of the Authority; or Charging Change Proposals – on behalf of a Wholesaler).	On behalf of Castle Water as Trading Party		
Contact Email	christopher.wright@castlewater.co.uk		
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The Proposer recommends that this Change Proposal/Charging Change Proposal should initially: <i>(delete as appropriate)</i>	Proceed to Assessment		
	Proceed to Consultation		
	Proceed to Recommendation		
Is the change Urgent (Yes/No)? If yes, please provide reason for urgency (if applicable)	Yes. There is a clear-cut case for correcting without delay the current discrimination against independent Retailers. There is no justification for the consequent increased financing costs for such		

	<p>Retailers. In circumstances where a Retailer achieves the highest possible level of credit score this should properly be recognised in the Credit Support Requirement as <u>at least</u> equivalent to the minimum credit rating.</p> <p>The change is straightforward. There is no reason why it should be controversial, or require extended treatment or remittance to the Credit Committee for further <i>ab initio</i> review.</p>
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Related Documents

Reference of any associated Code Panel Change Proposal/ Charging Change Proposal	N/A
Documents Accompanying Form	N/A

Change Proposal/ Charging Change Proposal Details

Description of (i) the issue or defect which this Change Proposal seeks to address, or (ii) the modified or new charging method or charging structure required pursuant to this Charging Change Proposal, as required under the Market Arrangements Code Section 6.2.1(b).

Section 9.11 of the Wholesale Contract, Schedule 1, Part 2: Business terms expressly provides for credit scores to be treated as alternatives to the credit ratings awarded by the Credit Rating Agencies (CRAs), the underlying principle therefore being that a credit score is analogous to a credit rating.

The Contract as drafted patently does not reflect this principle in a number of ways – for example by allowing credit scores to be reviewed or rejected by Wholesalers more frequently and with less notice or scope for remedy for the Retailer. This results in independent Retailers having to maintain excess balance sheet capacity.

In particular, there is a material unjustified discrepancy in the relative treatment of credit scores and credit ratings for the purpose of determining the Unsecured Credit Allowance (UCA), which this Proposal seeks to address.

At present, the four highest Credit Assessment Score bands are brigaded into two (7 & 8 and 9 & 10), providing for a UCA of 10% and 20% respectively to be applied to the Credit Support Requirement (CSR).

However, while the maximum Credit Assessment Score merits only a 20% UCA as above, a minimum credit rating merits a 40% allowance. The maximum possible UCA for a smaller company is therefore half of that available to a larger company, irrespective of their relative financial strengths.

This is discriminatory for the following reasons:

- First, in practice it is impossible for an independent Retailer to obtain a minimum credit rating as an alternative to a credit score. The weight given to scale in the credit metrics of

CRA (for example Moody's) means that such a rating cannot be gained by companies with less than US\$1.5 billion turnover, regardless of the strength of their balance sheets. This effect runs counter to the principles of the Code.

- Second, the use of credit ratings does not in any event reflect equivalence of creditworthiness with any degree of accuracy. A corporate credit rating does not give a rating to unsecured trade creditors. Consequently, the credit rating used under the terms of the Codes will only indicate the maximum degree of credit security, which may significantly overstate the real level of credit security to a trade creditor. This makes the inability of an independent Retailer to obtain the same credit terms as an Associated Retailer particularly artificial and discriminatory.
- As a result, Wholesalers' subsidiaries and Associated Retailers have access to lower capital costs than independent Retailers, even where they have lower credit metrics. (Some further distortions occur for historical and geographical reasons, where credit ratings have been awarded to some smaller regional utilities including certain Stadtwerke in Germany and Water-Only Companies in England, some of which have Associated Retailers within their corporate group.)

In competition law terms, these factors would constitute clear grounds for undue discrimination (a) in the sense that the gulf in the treatment of the two groups is simply too wide in absolute terms; and (b) that it is without any objective justification and hence arbitrary:

- To treat a maximum credit score less favourably than a minimum credit rating clearly creates an unbridgeable gulf.
- There can be no objective reason for affording more favourable treatment to a company that is able to acquire a credit rating through Group association, including historic scale, access to finance and parent company guarantees, whilst raising the financing costs of those relying on credit ratings, and creating an artificial barrier to entry and expansion.
- To an independent retailer, the provision of credit relates to its overall balance sheet capacity, and is equivalent to cash. The facilities it uses to provide credit support can also be used to make cash payments. However, for a vertically integrated group provision of credit support is an inter-company transfer. This results in a further distortion of the market in favour of vertically integrated companies.

There is a case for treating an independent Retailer with an Experian score of, say, >90 as having the financial standing to achieve an investment grade credit rating of BBB- in terms of unsecured credit rating, and receive a UCA of 40%. The current Proposal is therefore conservative in seeking that treatment for a credit score of >95.

Unlike the lower Credit Assessment Score bands, which are in ten-point steps, the two top bands are in five-point steps (90-94 and 95-100 respectively), suggesting that further granularity could easily be recognised. This Proposal is therefore to treat Band 10 as equivalent to a minimum credit rating.

Finally, we note that there is an obligation on the Market Operator, on Ofwat, and on all Trading Parties to act in the interests of the market. This cannot be achieved by maintaining an artificial and discriminatory barrier to the entry, expansion and efficient financing of independent Retailers.

Description of the Change Proposal/ Charging Change Proposal, its nature and purpose and (for Change Proposals only) how it is consistent with the Principles and falls within the Objectives noted below, as required under the Market Arrangements Code Section 6.2.1(c).

The Proposal will:

- Promote efficiency among, and mitigate an undue financial burden on, independent Retailers;
- Restore a degree of proportionality to the UCA arrangements;
- Make transparent the rationale for comparing Credit Assessment Scores against credit ratings;
- Contribute to the cost-effective functioning of the market;
- Reduce a barrier to entry and expansion; and
- Mitigate a serious element of discrimination against independent Retailers, taking account of competition law requirements,

in each case as detailed below.

The textual change proposed is to insert a new sub-sub paragraph (i) in sub-paragraph 5(b) of Schedule 2E to the Wholesale Contract, Schedule 1, Part 2: Business terms, and amend what will then become sub-sub paragraphs (ii) and (iii), as follows:

“(i) 10, then there shall be an allowance of 40% applied to the Credit Support Requirement; or

(ii) ~~9-or-10~~, then [...]”

(iii) [...]

Principles and Objectives

Description of the principles and objectives affected by the Change Proposal on the items below (if applicable) as detailed in Part A of Schedule 1 Part 1: Objectives Principles and Definitions.

Principles	Affected (Y/N)	Description
Efficiency	Y	The Proposal mitigates the need for an independent Retailer to deploy capital beyond the level necessary, and so contributes to the more efficient financing of such companies.

Proportionality	Y	The Proposal restores a degree of proportionality to a rule that currently applies arbitrary and more stringent criteria to independent Retailers.
Transparency	Y	The Proposal represents a clearer rationale for the UCA arrangements.
Simplicity, cost-effectiveness and security	Y	The Proposal will contribute to the cost-effective functioning of the market.
Barriers to entry	Y	As above, a barrier to entry and expansion will be reduced.
Non-discrimination	Y	The key driver for the Proposal is to mitigate the current overt discrimination described in detail above.
Customer participation	N	
Customer contact	N	
Seamless markets	N	
No limit on upstream competition	N	
Business Terms Objectives	N	
Operational Terms Objectives	N	
Market Terms Objectives	N	
Description of the impact of the Change Proposal/ Charging Change Proposal on the following items, as required under the Market Arrangements Code Sections 6.2.1 (f), (g) and (h).		
Configured Item	Impacted (Y/N)	Description
Schedule 1: Terms and Conditions of a Wholesale Contract	N	
Wholesale-Retail Code, Schedule 1 Part 1 (Objectives, Definitions and Principles)	N	
Wholesale-Retail Code, Schedule 1 Part 2 (Business Terms)	N	

Wholesale-Retail Code, Schedule 1 Part 3 (Operational Terms)	N	
Wholesale-Retail Code, Schedule 1 Part 4 (Market Terms)	N	
Wholesale-Retail Code, Schedule 1 Part 5 (CSDs)	N	
Wholesale-Retail Code, Schedule 1 Part 6 (Operational Forms)	N	
Appointment	N	
Licence	N	
Any other industry code, agreement or document (e.g. the Wholesale Contract or the MOSL Articles) (please specify)	Y	Wholesale Contract, Schedule 2E of the Business Terms: Unsecured Credit Allowance.
Central Market Operating System	N	
Trading Party systems which interface with Central Systems and other relevant Trading Party systems/ business processes.	N	
Scottish Core Industry Documents	N	
Further Information		
Description of any discussions on the topic of the Change Proposal/ Charging Change Proposal at the User Forum (as relevant) or otherwise relevant discussions with parties, as required under the Market Arrangements Code Section 6.2.1(i).		
This issue has previously been raised with Ofwat (including through KPMG in the context of its 2018 review of credit terms).		
Further Comments		
N/A		

Key

	To be completed by the Market Operator
	To be completed by the Proposer