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## Wholesale-Retail Code Change Proposal – Ref CPW018

<b>Modification proposal</b>	Unsecured Credit Allowance
<b>Decision</b>	Ofwat has decided to accept this change proposal
<b>Publication date</b>	23 October 2017
<b>Implementation date</b>	23 April 2018

### Background

The Wholesale-Retail Code (WRC) sets out the relationship between wholesalers and retailers, and how the market operates. Credit arrangements are an important aspect of any market arrangement. Credit arrangements that do not appropriately reflect the efficient, pro-competitive risk-sharing between wholesalers and retailers could:

- act as a barrier to entry, resulting in a chilling effect on the levels of rivalry and choice in the new market, to the detriment of customers and to the trust and confidence in the market;
- impact on financeability of wholesalers in extreme circumstances, if the credit arrangements do not adequately address the risks that wholesalers are exposed to; and
- lead to unnecessary costs, if the risks of default are not allocated efficiently. In these circumstances, credit arrangements may tie up capital that unnecessarily creates costs and inefficiency or encourages excessively risky entry and bad debts which may be passed on to customers.

Following lengthy consultation and engagement with the industry prior to market opening, the credit arrangements to open the business retail market were included in the WRC. These arrangements include a suite of six regulated credit options which retailers can use to provide the required credit support amount, the level of which (and how it is calculated) is set out in the WRC. One of the options available to retailers is to use an unsecured credit allowance to reduce (up to a maximum of 40%) the required credit support amount to be provided to wholesalers.

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The go-live version of the WRC included a provision for retailers to access an unsecured credit allowance based on the credit strength of a parent company. This proposal seeks to amend the wording of Schedule 2E of the Wholesale Contract Schedule 1, Part 2: Business Terms, so that a parent company credit rating cannot be used for the purposes of accessing an unsecured credit allowance.

## The issue

At present, a retailer can use its Parent Company's credit worthiness to reduce the amount of credit support it needs to provide, however, the risk of default for any given entity does not change merely because of its Parent Company's credit worthiness. Moreover, as there is no accompanying provision for the Parent Company to underwrite this credit, there is no clear line of sight between the retailer and its Parent Company such that the default risk is moved from the retailer to the Parent Company.

Thames Water, as proposer of this code modification (The Proposer), contends that the provisions relating to the unsecured credit allowance as currently written could unduly increase the risk borne by wholesalers and inadvertently cause a competition issue between retailers. It also believes that the current drafting of the WRC is potentially confusing and ambiguous.

## The Modification Proposal<sup>1</sup>

The Proposer of this code modification believes that Schedule 2E of the Wholesale Contract Schedule 1, Part 2: Business Terms should be changed and the reference to the parent company credit rating removed. The proposed amendments aim to clarify that a parent company credit rating cannot be employed by a retailer to gain access to an unsecured credit allowance.

The specific changes to Schedule 2E as proposed in this code modification are set out below:

*"2. where ~~(a) a Contracting Retailer and (b) the Parent Undertaking of a Contracting Retailer~~, holds a Current Credit Rating, this shall be used for the purposes of calculating or removing any Unsecured Credit Allowance. Where it holds two or more of such ratings it shall use the lowest rating provided*

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<sup>1</sup> The proposal and accompanying documentation is available on the MOSL website at <https://www.mosl.co.uk/market-codes/change#scroll-track-a-change>

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4. *all Unsecured Credit Allowances shall be calculated as follows:*

*(a) where a Current Credit Rating is provided for the Contracting Retailer ~~or its Parent Undertaking~~ that meets the Minimum Credit Rating or above there shall be an allowance of 40% applied to the Credit Support Requirement...*"

It is recommended by the Panel (see further under 'Panel Recommendation' section below) that these modifications come into effect on the first day of the calendar month at least three months following an Ofwat decision.

## **Industry consultation and assessment**

The Panel has considered this code modification at three separate meetings, and has carried out two separate consultations on this issue.

### **First industry consultation**

The initial code modification proposal that was the subject of this first industry consultation was focussed around ensuring that, in circumstances where retailers used their Parent Company's credit rating to access an unsecured credit allowance, this would be underwritten by the Parent Company via a guarantee.

This first Industry Consultation was issued on 31 March 2017<sup>2</sup>.

In total, 21 Trading Parties (15 wholesalers and six retailers) responded to this industry consultation, and the responses did not present a unanimous position. 11 of the respondents made the case that an alternative proposal could provide greater clarity and better facilitate the Objectives and Principles of the Code.

On 30 May 2017, the Panel considered the responses to the industry consultation and agreed to progress the change to an assessment process whereby MOSL and the proposer would develop an alternative solution, taking account of feedback received to the consultation. In particular, it was agreed that the focus should shift to whether there should be a provision for the reliance on parent company credit ratings for access to an unsecured credit allowance. We also indicated that the first industry consultation had not provided us with sufficient evidence as to the extent to which the current provisions were being utilised by retailers (and as such we would not be

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<sup>2</sup> Details of the consultation can be found at <https://www.mosl.co.uk/market-codes/change/details/17/clarification-of-unsecured-credit-allowance>

in a position to make a decision) and asked for the assessment process and subsequent consultation to address this issue, allowing for confidential responses.

### **Second industry consultation<sup>3</sup>**

MOSL and The Proposer developed the drafting of a revised solution which was then the subject of the second industry consultation. This revised solution (which forms the proposed code modification considered in this document) sought to make clear that a parent company credit rating cannot be used for the purposes of accessing an unsecured credit allowance. This second consultation also provided the opportunity for trading parties to provide confidential responses on the extent of their reliance on the provision proposed to be removed.

The Panel consulted on the revised Change Proposal on 29 June 2017, with the deadline to submit responses of 13 July 2017.

In total, responses were received from 12 Trading Parties (nine wholesalers and three retailers), with five companies choosing to provide confidential responses to questions 2, 3 and 4. The responses were largely supportive of the Change Proposal and the recommended implementation timetable (discussed further under 'Panel Recommendation' section below).

Key points arising from this consultation are set out below:

- Seven respondents to the consultation (five wholesalers and two retailers), noted that they currently have an arrangement in place for an unsecured credit allowance which is based upon the credit strength of a parent company. Responses suggest that there are at least five retailers who currently have arrangements in place for an Unsecured Credit Allowance which is based on a Parent Company's credit rating;
- Three respondents (two retailers and one wholesaler) noted that they do not have an unsecured credit allowance based upon a parent company's credit rating. However, one of these wholesalers noted that a retailer had requested to make such an arrangement but until the Codes had been clarified, a Parent Company Guarantee was being used for the totality of the required credit support amount under Schedule 2B;
- Of the seven respondents who noted that they do currently have arrangements in place for an unsecured credit allowance based on the strength of a parent company, one retailer believed that there may be an

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<sup>3</sup> Details of the consultation can be found at <https://www.mosl.co.uk/market-codes/change/details/17/clarification-of-unsecured-credit-allowance>

issue of extending their existing parent company guarantee to cover the additional collateral requirements should the change be implemented but that a review will be undertaken, and one retailer stated that they would need to review the level of guarantee provided with shareholders and, subject to that review, may potentially need to seek alternative sources of collateral;

- Five respondents (four wholesalers and one retailer) noted that a review of credit arrangements would be required and a different form of eligible credit will be used to cover the 40%; and
- One wholesaler noted that, although they have agreed on an unsecured credit allowance, the Eligible Credit Support they have in place with a retailer currently covers the Credit Support Amount, and therefore no adjustment is required.

The majority of respondents agreed with the proposed implementation date, if this change were to be accepted by Ofwat, of the first day of the calendar month at least three months following an Ofwat decision, with some respondents stating they would prefer a shorter implementation timescale.

However, two retailers disagreed with the proposed implementation timetable, making the following points:

- The timeframe may be too short to obtain agreement with the relevant wholesaler(s) for the changes to the credit arrangements, approval with the corporate structure of the parent company and new legal documentation to be drawn up and agreed. In addition, the timescales may be too short due to the timing of corporate meetings and the availability of key decision makers within the parent company.
- A three-month period is not an appropriate timescale to implement the proposed change, with a six-month period being more reasonable. The retailer in question estimates that it would take at least three months to put new credit arrangements in place if the parent company agreed to extend the current Parent Company Guarantee to cover the unsecured credit allocation. However, if this is not forthcoming, then the retailer would have to review its financing strategy and potentially seek funding from elsewhere, which would need to be compliant with existing funding arrangements, and would need to go through the relevant corporate governance procedures. It is estimated that this process would take six months to complete.

## **Panel recommendation**

At its meeting on 25 July 2017, the Panel reviewed the consultation responses received and considered its recommendation to Ofwat. The Panel determined, by a majority decision, to recommend this Change Proposal to Ofwat for implementation

on the 1st of the month falling three full months after an Ofwat decision. The Panel submitted its recommendation report to Ofwat on 28 July 2017, which set out the Panel's view that this change improves the Principles of efficiency, transparency, barriers to entry, non-discrimination and seamless markets.

## **Our decision**

We have carefully considered the issues raised by the modification proposal and the supporting documentation provided in the Panel's recommendation report, including a review of precedents in other sectors. We have paid particular attention to the responses received to the industry consultations.

On balance, we have concluded that the implementation of CPW018 will better facilitate the principles and objectives of the WRC<sup>4</sup> detailed in Schedule 1 Part 1 Objectives, Principles and Definitions and is consistent with our statutory duties and this is set out further in the 'Reasons for our decision' section, below.

However, we have decided not to accept the Panel's recommended timescale for implementation.

The Panel has recommended an implementation date of the 1<sup>st</sup> day of the month falling three full months after an Ofwat decision to approve the modification. The rationale for this appears to be that this time period was considered to provide a balance between allowing sufficient time for affected parties to put in place revised credit arrangements and limiting the exposure of wholesalers who are party to such arrangements.

As part of the second consultation, 10 of the respondents (nine wholesalers and one retailer) agreed with the implementation date believing that this provided sufficient time for retailers to review and amend credit arrangements. Of these respondents, the retailer in question does not have arrangements in place whereby it has used a parent company to access an unsecured credit allowance, and four wholesalers who agreed with the proposed implementation timescale have agreements in place with retailers that rely on this provision. Two retailers, however, who currently rely on their parent's credit rating for unsecured credit argued that the proposed date did not leave sufficient time to arrange a replacement parent company guarantee or other credit support, one arguing that six months was a more appropriate and realistic timeframe.

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<sup>4</sup> Available at <https://www.mosl.co.uk/market-codes/codes>

It is clear from the evidence provided that there are a number of retailers who currently rely on this provision and will have to find alternative credit support arrangements as a result of our decision. Retailers who responded to the consultation have argued that any shareholder engagement will need to go through relevant governance processes, including presentations to Treasury Committees and PLC Boards, which they estimate would take at least 3-4 months. We are aware that longer timescales may be involved if a PCG extension is not forthcoming.

Given the complexities associated with corporate financing, structures and governance, or failing that obtaining alternative credit support, we think that it is possible that it could reasonably take retailers up to six months to transition to new credit arrangements.

In addition, we recognise this is a major change to policy that affects a number of retailers who entered the market on a legitimate basis, and we acknowledge that the consultation period carried out was a short one and as a result only three retailers directly engaged in the consultation. We are mindful that there are other retailers who are utilising the current provision who will also need time to regularise their credit arrangements. As such, we consider it appropriate to allow additional time for implementation to ensure that all affected retailers have sufficient time to make alternative arrangements.

We have therefore decided that this Code modification should be implemented six months after the date of this decision, but we expect affected retailers to establish alternative credit arrangements as soon as reasonably possible after the date of the decision. We would encourage wholesalers who are party to such agreements to proactively engage with all affected retailers at an early stage to discuss with them these forthcoming changes.

By adopting this position, we are mindful of the need to balance wholesalers' risk exposure with the need to provide sufficient time for those who entered the market, in good faith in reliance on the provisions for unsecured credit in the WRC, to make alternative credit arrangements. Therefore it is our view that it would be reasonable to provide a longer implementation timetable than that recommended by the Panel.

## **Reasons for our decision**

We set out below our views on which of the applicable Code principles are better facilitated by the modification proposal.

### **Efficiency**

In our view this proposal promotes the efficient, economic and innovative operation of the water and wastewater sector by removing ambiguity in the Business Terms, thus reducing risk of dispute between Trading Parties.

The credit terms were devised, following consultation, on the basis that retailers bear 60% of the credit risk and wholesalers the remaining 40%. This was considered to promote efficient and effective competition.

In the absence of this code modification, we think that this risk sharing allocation is incompatible with the 60/40% split as described above. This is because the default risk of the retailer does not change simply as a result of its parent companies' credit worthiness and as a result, retailers relying on this provision results in the counterparty wholesalers taking on additional exposure to default risk beyond the 60/40% risk sharing allocation. No evidence has been provided as to why it is efficient or pro-competitive to maintain this deviation from the standard 60/40% split.

## **Transparency**

We agree with the Panel that this change proposal is consistent with the principle of improving Transparency. We consider that the introduction of the revised wording improves the Code in terms of being concise and clearly expressed.

## **Non-discrimination**

In its recommendation report, the Panel notes that this Change Proposal will reduce the potential for accidental discriminatory treatment of retailers. Our concern here is that, without making this code modification, retailers with identical risk profiles and similar levels of default risk are being treated differently.

This could raise level playing field concerns because, as set out above, the risk of default does not change as a result of the parent's creditworthiness, so retailers with similar levels of credit worthiness are in this context being treated differently. We therefore think that this code modification addresses this issue.

## **Decision notice**

In accordance with paragraph 7.2.8 of the Market Arrangements Code, Ofwat approves this change proposal.

**Cathryn Ross,  
Chief Executive**