
Wholesale Retail Code Change Proposal – Ref CPW019

Modification proposal	Wholesale Retail Code Change Proposal CPW019 – Alternative Eligible Credit Support
Decision	Ofwat has decided to approve this change proposal
Publication date	23 July 2018
Implementation date	31 July 2018

Background

The Wholesale Retail Code, Schedule 1, Part 2: Business Terms provides that retailers may opt for pre or post-payment of Wholesale Charges¹. Where retailers opt for post-payment, section 9.11 of the Business Terms sets out the Credit Support Requirements. There is a requirement that retailers provide and maintain Eligible Credit Support and/or Alternative Eligible Credit Support which is at least equal to the Credit Support Amount as defined within the Wholesale Retail Code. The formula for calculation of the Credit Support Amount is set out in section 9.11.3 of the Business Terms, and includes a reduction of the Credit Support Amount where the retailer has accrued interest from cash deposited in the Cash Security Account and/or has access to an Unsecured Credit Allowance (UCA).

Where a new entrant retailer is unable to gain access to UCA, it is required to rely solely on a combination of Eligible Credit Support and/or Alternative Eligible Credit to cover the Credit Support Amount.

The proposal to introduce an alternative method for accessing UCA was initially raised in June 2017. A number of different options have since been considered as part of this proposal. One such example being the use of an Escrow Account, managed by an Escrow Agent, backed by insurance. A Panel Sub-Group was established and a meeting held to explore options, discuss the concerns identified with the proposal and establish whether these could be addressed. It was the view of the Sub-Group that the proposal would be costly to operate, highly complex and

¹ Section 9.2.1 of the Wholesale Retail Code, Schedule 1, Part 2: Business Terms

difficult to manage in practice. Therefore, an alternative solution was developed and has now been proposed to the Authority by the Panel.

The issue

The Water Retail Company, as Proposer, considers that the forms of credit support currently prescribed in the Codes are not commercially viable for retailers who do not have a credit history or access to a Parent Company Guarantee. It has been suggested that this is a material issue which discourages or potentially prevents small retailers from entering the market. If a new entrant is unable to gain access to UCA then the combination of Eligible Credit Support options and/or Alternative Eligible Credit options would need to be relied upon.

The modification proposal²

It has been proposed that retailers with appropriate Trade Credit Insurance (TCI) in place should be able to access UCA. TCI usually covers a portfolio of customers and in the event of non-payment by those customers (due to specified reasons) the policy pays out an agreed percentage of the unpaid amount. Where a retailer provides evidence of a TCI policy, which adheres to the specified Key Terms, then it is proposed that it would be able to gain access to UCA of a specified percentage.

It is proposed that Schedule 2G is introduced into the Business Terms to provide the Key Terms for the TCI policy, these include the following:

1. The TCI must be provided by a Financial Conduct Authority authorised insurer and be an insurance industry standard TCI policy as described by the Association of British Insurers.
2. For each Supply Point that is covered, the policy must pay out no less than 90% of the value of the Primary Charges relating to that Supply Point.
3. The policy must enable the Contracting Retailer to claim under it, within six months of an event of a default by the Non-Household Customer. An event of default is defined within in the Key Terms.
4. The Contracting Retailer must provide the Contracting Wholesaler with a form of self- certification in the prescribed format each Month.
5. The percentage of insurance shall be used to determine the UCA.
6. The Contracting Retailer must provide the Contracting Wholesaler (on no less than five Business Days' notice) access to check the status of the TCI policy and level of cover at any reasonable time.

² The proposal and accompanying documentation is available on the MOSL website at <https://www.mosl.co.uk/market-codes/change#scroll-track-a-change>

7. A Contracting Retailer shall only be entitled to rely on TCI as a form of UCA for a period of no more than three years from the date on which the Contracting Retailer becomes a Trading Party.

The size of the UCA available to the relevant retailer would be based upon the percentage of a retailer's total portfolio covered by the TCI. Where the TCI covers in excess of 90% of its portfolio, it is proposed that there will be an allowance of 20% applied to the Credit Support Amount which would in turn reduce the Credit Support Requirement. There would be an allowance of 10% where the policy covered between 70% - 90% of the portfolio. No allowance would be applied to the Credit Support Amount where the TCI policy covered less than 70% of the retailer's portfolio.

Only a single UCA can be accessed, either on the basis of a credit score, credit rating or TCI policy (but not in combination). It is proposed that retailers should not be able to stack or combine UCA's. Once the retailer has been operating for three years or more it will no longer be able to access UCA through TCI as by this time, it should have sufficient trading history to enable it to obtain a credit score or rating. In addition, TCI can only be used to access up to 20% UCA, the other 80% will require alternative collateral (whether that be cash deposit or an alternative form of credit).

It is proposed that the level of TCI required to obtain UCA should be considered at an aggregated national level. This is because the use of TCI policy is intending to reflect the risk associated with the retailer's overall financial stability and not its specific regional financial stability. This approach of considering risk and the resultant UCA at an aggregated national level is consistent with the approach taken when credit ratings and credit scores are utilised. Credit ratings and credit scores, which can be used to access UCA, provide a view of the credit worthiness of the retailer's business as a whole and do not have regional variations to reflect the business' performance in different wholesale areas. TCI could be viewed as a more informed reflection of a company's credit risk as it is based on actual customers who will have a credit history.

The change proposal suggests that the above should be incorporated into the Business Terms by making the following amendments:

- Add TCI as a legitimate basis for accessing UCA;
- Define the Key Terms required for a qualifying TCI policy;
- Set out the obligations that provide visibility for a wholesaler of the coverage of any such policy held by a retailer; and
- Set out the UCA accessible by a retailer (as a percentage), on the basis of holding a qualifying TCI policy.

Industry consultation and assessment

Industry consultation on this proposal commenced on 13 April 2018 and concluded on 27 April 2018. Industry views were sought in relation to 10 questions. In total, there were 21 respondents, 13 wholesalers and eight retailers.

Response to industry consultation was mixed. However, overall the majority of respondents were in favour of approving this change proposal. Key points raised in response to the consultation are discussed further below. A more detailed overview of the consultation responses has been included in Appendix 1 of this document.

Limited accessibility

Two wholesalers and two retailers suggested that TCI would be expensive and therefore would not necessarily be a viable option for new entrant businesses. However, three other retailers and one other wholesaler thought that TCI could be a cost effective way of helping to reduce a barrier to entry.

One wholesaler and one retailer argued that TCI would only be a viable option for retailers who have a number of 'blue chip' customers rather than a range of small and large customers. Another retailer pointed out that typical excesses on TCI policies are around £1,000 and therefore, TCI would only be a viable option for larger Supply Points. The Water Retail Company however, claimed that excesses could be as low as around £200.

The Panel Sub-Group agreed on balance that this change proposal would encourage participation in the market, which would facilitate new retailer entrants, diversification and improved competition. It also suggested that TCI was not unduly complex and therefore, would benefit a wide range of retailers in the market, including new entrants and smaller participants.

Wholesaler risk

There was a mixed response to the consultation questions on wholesaler risk exposure. Most respondents thought that TCI reduced wholesaler risk with one respondent expressing the view that TCI is more tangible than a credit score.

When asked "in what way, and under what circumstances, might the existence of TCI reduce wholesaler exposure to a retailer's credit risk?", nine out of 21 respondents thought that the use of TCI might reduce wholesaler exposure to a retailer's credit risk. It was however, suggested by two wholesaler respondents that they thought that wholesaler risk would be increased because the retailer would not

need to post as much collateral, which they considered to be a more reliable protection against bad debt than TCI. One retailer and one wholesaler also pointed out that the retailer rather than the wholesaler would be the named beneficiary on the TCI policy. In the event of liquidation, the wholesaler would potentially be one of a number of unsecured creditors and therefore at risk of not receiving payment.

One wholesaler respondent expressed concern that this credit option would be available for new entrants who had been trading elsewhere but had obtained a bad credit rating. If a new entrant had a poor credit rating, whilst it may be able to gain access to the TCI option, the likelihood is that it would struggle to obtain other credit options to cover the additional 80% of UCA. As such, it may have to use the pre-payment route or for example, a cash deposit. Therefore, the perceived increased risk to wholesalers is potentially somewhat mitigated by the access to UCA using TCI being limited to a maximum of 20% and for a period of up to three years.

The Panel Sub-Group considered the concerns raised in response to the questions covering wholesaler risk. The group appreciated the perception that wholesaler risk could be viewed as being increased. However, it highlighted that the use of TCI would only permit access of up to a maximum of 20% of UCA dependent on the level of cover the retailer holds. Therefore, it considered that the risk was sufficiently mitigated as the other 80% of UCA would still have to be covered by Eligible Credit Support and/or Alternative Eligible Credit Support.

The level of access to UCA

Eight out of 18 respondents to this question (six wholesalers and two retailers) felt that the proposed UCAs available where a retailer had TCI were too generous. In their view, TCI is not equivalent to having a credit score or rating and only marginally improves credit worthiness. In addition, it was suggested that consideration should be given to an overall financial cap.

One retailer respondent considered that the proposed UCAs were disproportionately low as up to 90% of the retailer's total portfolio could be covered by TCI.

The Panel Sub-Group considered the consultation responses and on balance considered that the proposed amounts were appropriate. It highlighted that there is effectively already a financial cap in place as access to UCA is limited to a maximum of 20%. It concluded that this proposal introduces a new credit option and therefore, the proposed levels of UCA would need to be sufficiently attractive to encourage participation in the market. In addition, it did not consider that the proposed levels presented an undue risk to wholesalers in the market and that they were consistent with other forms of UCA. As such, no change was made to the proposed levels of access to UCA based on TCI.

Panel recommendation

The Panel considered this change proposal at its meeting on 29 May 2018 and agreed to recommend CPW019 to the Authority for approval.

10 out of 11 Panel Members agreed to recommend approval and one Unassociated Retailer Panel Member disagreed. The Panel Member who did not agree, voted against the proposal on the grounds that they felt UCA should be a reward for well established businesses, rather than an entitlement of all parties. However, this Panel Member recognised that currently there is an imbalance with access to credit options in favour of incumbent parties and this proposal may go some way to address the imbalance.

Our decision

We have carefully considered the issues raised by the modification proposal and the supporting documentation provided in the Panel's recommendation report. We have also reviewed additional documents that the Panel Sub-Group considered during its meeting on 28 February 2018. These documents set out initial analysis and proposed drafting, that helped form the consultation issued in April 2018. We have concluded that the implementation of CPW019 will better facilitate the principles and objectives of the Wholesale Retail Code³ detailed in Schedule 1 Part 1 Objectives, Principles and Definitions and is consistent with our statutory duties.

Reasons for our decision

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

Efficiency

This proposal brings benefits for efficiency as it will be an alternative option which may allow trading parties to avoid undertaking time consuming negotiations to agree bespoke arrangements which take account of the credit risk mitigation properties of TCI. In addition, the proposal may encourage new market participants which in turn would help to promote efficiency through competition.

³ Available at <https://www.mosl.co.uk/market-codes/codes>

Barriers to Entry

The proposed change offers an alternative arrangement for new entrants to the currently prescribed credit options in the Codes. In addition, it potentially removes the requirement to negotiate a bespoke agreement with the relevant wholesaler which takes account of the impact of TCI on a retailer's creditworthiness. This in turn contributes to the reduction of a barrier to entry as new entrants would be able to more easily access credit.

We have reviewed the consultation responses which suggested that TCI may not be a viable option for new entrant businesses due to the cost of such policies. We note that whilst these concerns have been raised, it is likely that an existing retailer will utilise this form of credit. The indication that a retailer would use this option suggests that this may be a financially viable option which will contribute to reducing a barrier to entry.

We note that the Panel Sub-Group also gave consideration to the view that this option would be available to a range of retailers including those with a variety of different types of customer and business models. We note that there is no evidence provided to support this assertion, nor evidence to suggest it is not correct. The full picture of accessibility to and take up of TCI will only become apparent if this code modification is implemented. Given that we have information to suggest that this would be utilised if approved, on balance, we consider this code modification should be approved as it will assist in reducing a barrier to entry.

Further to the above, we have considered the consultation responses which suggested that the use of TCI would increase wholesaler exposure to risk. The use of TCI would only allow access to UCA of up to a maximum of 20% and the remaining 80% would be required to be made up of Eligible Credit Support or Alternative Eligible Credit Support. Given this, and that this option will only be available to new entrants and for a limited time only to help address initial entry barriers, it is not considered that wholesaler risk will be disproportionately increased.

Non-discrimination

By introducing an alternative option for new entrants the proposed change seeks to address the imbalance in the number of credit options realistically available to new entrants when compared to incumbent parties.

Decision notice

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

Emma Kelso

Senior Director, Customers and Casework

Appendix 1: Industry consultation

Question 1: In what way, and under what circumstances, might the existence of TCI reduce the wholesaler exposure to a retailer's credit risk?

The majority (15 out of 21) of respondents felt that the existence of TCI would reduce the wholesaler exposure to a retailer's credit risk in principle.

Of the five respondents who did not agree, four were wholesalers and one was a retailer. It was suggested by these respondents that TCI protects the retailer from non-payment from its customers however, the wholesaler is reliant upon the retailer to use those funds to pay wholesale charges. Therefore, should the retailer go into liquidation, the wholesaler would be one of a number of unsecured creditors meaning it still has exposure to risk. Another wholesaler respondent suggested that because of the above, the wholesaler risk was increased.

One wholesaler considered that the change proposal would only benefit one retailer as credit insurers will only grant credit to customers who are credit worthy enough. It also highlighted that a retailer with a broad customer range would not be able to achieve 90% coverage from TCI. This respondent felt that that would only be available to a retailer trading with a few blue chip companies.

The Panel Sub-Group acknowledged the view that wholesaler risk could be increased. It has highlighted that the increased risk would be small as 80% of the Credit Support Amount would be covered by Eligible Credit Support or Alternative Eligible Credit. Alternative Eligible Credit can be refined by the wholesaler to reflect its assessment of the overall risk.

Question 2: Do you agree that the Key Terms for insurance are adequate for the Trade Credit Insurance to be considered as the basis for accessing UCA? Please explain your answer.

Eight of the 21 respondents (seven wholesalers and one retailer), did not agree that the Key Terms for insurance are adequate for the TCI to be considered as the basis for accessing UCA. A number of drafting changes were proposed. In response to these, the Panel Sub-Group made changes to the proposed legal drafting. Full detail regarding the amendments made can be found in the 'CPW019 – Industry Consultation Responses' document.

In response to this question, concern was raised by two wholesalers regarding the self-certification process. It was suggested that wholesalers should have the right to audit the TCI policy as wholesalers are exposed to a compliance risk if a retailer does not properly comply with the terms of its TCI. The Panel Sub-Group considered

that this was already covered within the Business Terms under Schedule 2G (Term 6) therefore, no further change was thought to be required.

Concern with the timeframe of availability was raised by one wholesaler who suggested that the eligibility for access to UCA by utilisation of the proposed change should be one to two years following entry, not three. The respondent suggested that it should have been possible to obtain a conventional credit rating during three years of operation in the market. The Panel Sub-Group consider that three years is a reasonable time period for a business to begin trading following granting of its licences and become a trading party.

One wholesaler highlighted that Term 4 of the Key Terms requires that a retailer must be able to claim under the TCI in the event of insolvency or outstanding debit arising. Outstanding debt is a defined term within a timescale of 90 days or more. The respondent felt if a retailer was unable to pay the wholesaler due to defaulting customers, it could become a defaulting party before it is able to claim on its TCI. The Panel Sub-Group considered that this would not have a material impact on wholesalers as the TCI policy could only be used to make up 20% of the UCA.

It was also suggested that the wholesaler should be made the beneficiary of the TCI policy. The Panel Sub-Group confirmed in its response to consultation comments that it would always be the retailer who is responsible for payment of the wholesale charges and this responsibility could not be passed onto the insurer.

A retailer indicated that the Key Terms mean that the use of TCI would be limited to large Supply Points due to the level of excess on TCI policies. Another retailer indicated that the Key Terms mean that the use of TCI would be limited to large Supply Points due to the level of excess on TCI policies.

Question 3: Do you consider that the proposed levels of UCA based upon the financially insured values of the TCI are appropriate? Please indicate any alternative levels and associated ranges that you assess as being more appropriate and provide alternative rationale, and quantification if possible, for those alternatives.

Nine respondents, six wholesalers and four retailers, did not consider the proposed levels of UCA based upon the financially insured values of the TCI are appropriate. Those that considered the proposed levels of UCA appropriate, stated that the levels were the right balance between limiting wholesaler's exposure to risk and reducing barriers to entry for retailers. In addition, it was noted that the proposed levels appear consistent with UCA's accessed based on credit ratings that would apply when TCI would no longer be an option after the first three years of trading.

Five respondents to the consultation felt that the proposed levels of UCA were too high, and suggested the upper limit be reduced to 10-15%. The rationale for this was that the level should recognise the existence of the TCI policy but not provide equivalent weighting to this as a normal credit score.

The Panel Sub-Group reviewed the above consultation responses and considered that the proposed levels are appropriate. It considered access to UCA would encourage participation in the market and that the proposal does not place any undue material risk on wholesalers. In addition, the Panel Sub-Group suggested that the proposed levels are consistent with other forms of UCA.

One retailer suggested that a UCA of 20% was disproportionately low and suggested that the use of Credit Scoring Agencies, whose scoring reports are already utilised within the Business Terms. Their recommendations of appropriate credit limits and contract limits could be used to determine the level of UCA provided to retailers. The proposer informed the Panel Sub-Group that Credit Score Agencies would not take TCI into account. The Panel Sub-Group agreed that any consideration of the use of Credit Score Agencies should be considered as a separate change proposal.

Two wholesalers also suggested that consideration should also be given to an overall financial cap to limit wholesaler exposure. One wholesaler stated the cap could be somewhere in the order of £250,000 (representing 10% of a £2.5 million requirement). The Panel Sub-Group considered that the cap of 20% maximum UCA was a sufficient cap and did not consider a further cap to be appropriate at this stage.

Question 4 – Do you believe this change would encourage participation in the Non-Household water retail market? Please explain your answer.

14 respondents, seven wholesalers and seven retailers, agreed. Six wholesalers and one retailer did not agree that the change could encourage participation in the non-household retail market.

There was suggestion that the scheme is unduly complex and that wholesaler innovations could remove the requirement for this code change. It was also by a retailer that many wholesalers are developing Schedule 3 options for new entrants although a few are not. The Panel Sub-Group did not consider that TCI was unduly complex.

One wholesaler highlighted that the cost of the TCI would increase the retailer's cost to serve customers and potentially outweigh the collateral requirement reduction.

It was highlighted by one wholesaler that retailers have an extensive range of credit open to them. It was suggested that perhaps more than any other equivalent market.

Another retailer considered that this code modification would support new entrants strategically targeting large customers. It proposed that the wholesaler could take out insurance over the retailer, this approach reportedly works successfully in other wholesale utility markets.

The Panel Sub-Group concluded that on balance TCI would encourage new entrants to the market, diversification and improved competition. It did not consider it to be overly complex and therefore, advises that it would benefit a wide range of participants in the market, including smaller entrants.

Question 5 – Would this approach be of benefit to a range of retailers without unduly impacting the balance of risk between wholesalers and retailers? Please provide an assessment of any material change in risk that this proposal may introduce for wholesalers.

Eight respondents (seven wholesalers and one retailer) did not agree that the proposal brings benefits to a range of retailers without unduly shifting the risk to wholesalers.

It was suggested by six wholesaler respondents that the proposed change would increase wholesaler risk. One wholesaler also indicated that the proposed change could encourage entrants into the market who may not be creditworthy which in its view would increase the wholesaler exposure to risk.

One wholesaler highlighted that whilst it considers TCI would indirectly improve a retailer's credit worthiness, there are other business risks which cannot be accounted for by utilising TCI. There was concern amongst some wholesalers that TCI would only provide a marginal credit worthiness improvement and therefore the Unsecured Credit Support Amounts of between 10%-20% are not justified. It was reiterated by a wholesaler that the wholesaler risk is potentially increased due to the risk of non-payment if a retailer were to go into liquidation.

A number of respondents felt that there would be a limited number of beneficiaries should the proposed change be implemented. One wholesaler suggested awaiting the KPMG report before considering this change proposal.

One wholesaler considered the possibility that the new entrant retailer could have been trading elsewhere but has a bad credit rating due to occurrences prior to its entering the Non-Household water retail market. That new entrant would be able to use TCI to gain access to UCA.

In support of the proposal, one wholesaler highlighted that TCI would only cover part of the Credit Support Notice and that an alternative credit option would be required to cover the remainder. Therefore, it considers that the risk is 'distributed'.

The Panel Sub-Group concluded that whilst introducing TCI does impact the balance of risk between wholesalers and retailers it believes that the approach has minimal impact on the risk.

In addition to the above, it was suggested by one retailer that the TCI option should not be made available to self-supply licensees. The Panel Sub-Group considered this point and concluded that self-supply licensees would not be able to take out the insurance as on a practical level they would not be able to ensure against non-payment by themselves.

Question 6 – Please outline any implementation costs to your organisation arising from the implementation of CPW019.

15 out of 21 respondents highlighted that the cost of implementation would be negligible or very small.

Four wholesalers suggested that the cost of implementation will be dependent on the level of uptake by retailers. One wholesaler suggested that this change proposal would cost around £10,000 to implement due to changes in its internal system and staff training.

The Panel Sub-Group acknowledged the expectations of costs and overall considered these to be minimal.

Question 7 – Please outline any ongoing operational costs to your organisation following implementation of CPW019

The majority of respondents felt that there would be no (or minimal) operational costs should this proposal be implemented. One wholesaler however, highlighted that wholesalers may be at risk of incurring increased risk of incurring higher bad debt costs if compelled to accept reduced levels of collateral.

The Panel Sub-Group reflected upon the views of respondents in relation to ongoing operational costs and considered these costs to be minor.

Question 8 – Please outline any monetary benefits that CPW019 may bring to your organisation and whether you feel these benefits will outweigh the cost of implementation.

Of those that responded to this question, one retailer considered that there would be a monetary benefit. That retailer suggested that the monetary benefit would be a reduction in credit support requirements of 20% which would outweigh the cost of insurance at no additional cost to wholesalers. Another retailer felt that the costs of the TCI would outweigh any benefit the proposal could bring.

The majority of respondents felt that there would be no or minimal monetary benefits as a result of this change proposal. Although, one wholesaler considered that TCI would be a tool to reduce wholesaler exposure to a retailer's credit risk which could be viewed a monetary benefit.

The Panel Sub-Group acknowledged that the monetary benefits would be minor however, highlighted that there would be wider benefits outside of monetary terms. It considered that this proposal may encourage new entrants to participate in the market.

Question 9 – Do you agree that the proposed change better facilitates that Objectives and Principles of the WRC? Please explain your answer.

Of the 19 respondents who provided an answer to this question, seven wholesalers and two retailers did not consider that this proposal furthered the principles and objectives of the WRC. One reason provided was that the change would not further the principle of proportionality as the cost of the TCI policy for new entrants was thought to outweigh the benefit that having this policy in place would bring. It was the view of one respondent that no standards have been provided for the TCI policy and it is unclear how many providers of this type of policy are on the market. It was considered that this change proposal would bring benefits for a limited number of retailers.

The Panel Sub-Group considered responses and concluded that the proposed change would remove a barrier to entry and assist in encouraging new participants in the market which would in turn lead to diversification of the market. This view was shared by respondents who agreed with this question.

Question 10 – Do you agree with the implementation date of 31 July 2018? Please explain your answer.

13 respondents (seven wholesalers and six retailers) agreed with the implementation date. Those that agreed did so as the extent of changes required as a result of the proposal are considered to be small.

Six respondents (five wholesalers and one retailer) did not agree. It was suggested that the implementation date should be put on hold until the results of KPMG's

review of credit arrangements had been published. The Panel Sub-Group considered this point and noted that Ofwat had indicated this proposal should not materially impact the outcomes of KPMG's review. The Panel Sub-Group therefore, agreed to recommend the proposed implementation date of 31 July 2018.