

WHOLESALE-RETAIL CODE CHANGE PROPOSAL/ CHARGING CHANGE PROPOSAL

For use by the Panel

Change Proposal Reference <i>(To be completed by the Panel Secretary)</i>	CPW018	Version No	2.0
Submission: <i>(delete as appropriate)</i>	Change Proposal		
	Charging Change Proposal		
Title: of Change Proposal/Charging Change Proposal	Part 2: Business Terms amendment – Unsecured Credit Allowance		
Summary: of Change Proposal/Charging Change Proposal <i>(no more than two sentences)</i>	Proposal to enhance the clarity of wording for the use of parent company credit ratings and a parent company guarantee for the purposes of obtaining an Unsecured Credit Allowance.		
Status of the Change Proposal/Charging Change Proposal <i>(To be completed by the Panel Secretary)</i>			
First Time Published	10/03/17	CP - Rejected	
CP - Assessment		OFWAT - Further Information required	
CP - Consultation	30/05/17	OFWAT - Approved	
CP - Recommendation		OFWAT - Rejected	
CP - Further Information Required		Approved and Implemented in Code	
General Details of the Proposer			
Name of Proposer	Geoff Parker-Naples		
Capacity (for Change Proposals – on behalf of a Party, as a Panel member, as the customer representative or on behalf of MOSL or the Authority; for Charging Change Proposals – on behalf of a Wholesaler).	Trading Party		
Contact Email; Tel/Mob.	Geoff.ParkerNaples@thameswater.co.uk		
The Proposer recommends that this Change Proposal/Charging Change Proposal should: <i>(delete as appropriate)</i>	Proceed to Consultation		

Rationale for recommendation and any reason for urgency	This change is proposed to improve clarity around the use of a Parent Company's credit rating, in order to avoid issues of a level playing field and additional risk on wholesalers.
Related Documents	
Reference of any associated Interim Code Panel Change Proposal/ Charging Change Proposal	Part 2: Business Terms
Documents Accompanying Form	Briefing Note to Panel
Change Proposal/ Charging Change Proposal Details	
Description of (i) The enhancement, 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).	
<p><u>Background:</u> The 'go-live' version of the Wholesale-Retail Code' was published on the 20th February 2017. It included a revision to Schedule 2E of the Business Terms drafting that appears potentially confusing and ambiguous. This code change proposal recommends an enhancement to the wording to remove that ambiguity and to make clear the requirement for a Parent Company to provide a Guarantee when its subsidiary Retailer relies upon it to access an Unsecured Credit Allowance.</p> <p><u>Issue and Recommendation:</u> The wording in Schedule 2E of the Business Terms is potentially ambiguous and difficult to interpret and as such may lead to materially differing interpretations leading to disputes.</p> <p>Critically, with the additional provision whereby a Retailer can now use its Parent's credit worthiness to reduce the amount of credit support it needs to provide, there is no accompanying provision for a Parent Company Guarantee to underwrite this reduction in credit. There is no clear line of sight between the Retailer and its Parent in the Business Terms for the provision of a Guarantee by the Parent. It is important to note that the risk of default for any given entity does not change merely because of its Parent's credit worthiness.</p> <p>It is critically urgent to address this issue as the posting of credit support is occurring presently, and any disputes around this matter may undermine the reputation and operation of the market at its opening and on an ongoing basis.</p> <p>It is recommended that the drafting in Schedule 2E of the Business Terms is enhanced for clarity and an additional statement appended making it clear the if a Retailer uses it Parents' Credit Rating to reduce the amount if credit support it is to provide, then the Parent underwrites the variation in the credit support required to be posted by the Retailer with the Wholesaler directly.</p> <p><u>Examination of the drafting</u></p> <p>Examining the revised wording in clause 2 of Schedule 2E of the Business Terms, see below. The text in blue is the additional to that issued for the statutory consultation.</p>	

Key Terms

An Unsecured Credit Allowance shall be available to the Contracting Retailer in the following terms:

...

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;

The use of the word 'and' in the first sentence may be interpreted such that the Retailer and its Parent Company [Undertaker] must have a Current Credit Rating to calculate and access an Unsecured Credit Allowance. This could be interpreted to impose a higher hurdle for Retailers to access an Unsecured Credit Allowance.

The last sentence uses the word 'it' which made sense when the previous sentence was merely referring to a Retailer. However, it now becomes unclear as it is not possible to interpret which 'it' is being referred to; Retailer, Parent or both.

Examining the revised wording in clause 4 of Schedule 2E of the Business Terms (the text in blue is the additional to that issued for the statutory consultation):

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; or

Use of the word 'or' in the first sentence makes it clear that a Parent Undertaking who meets the Minimum Credit Rating will result in the Retailer being given the 40% Unsecured Credit Allowance. It fails to require that this 40% Unsecured Credit Allowance is underwritten by said Parent Undertaking. Critically, this means that the overall Credit Support provided to the Wholesaler is not reflective of the ongoing and unchanged risk of default of the Retailer, thus increases the financial risk to the Wholesaler.

The Market has two significant and real issues:

1. By way of example, consider two Retailers which are identical in terms of default risk. One is allowed to provide less credit support because it has a Parent Company that meets the Minimum Credit Rating requirement, and therefore incurs lower financing costs. The second Retailer, which is equally risky but does not have the benefit of a Parent's credit rating, is disadvantaged as a result of an arbitrary corporate structure. The lack of a provision requiring a Parent to underwrite the Retailer could be taken advantage of, whereby a credit-worthy Retailer creates a subsidiary which is not credit worthy, and arbitrages the credit support arrangements.
2. The high level principle of the 60/40 split of the default risk between Retailer and Wholesaler is not upheld. The principle of the Credit Support Allowance is to reflect that the more credit worthy a Retailer is, the less default risk they carry and therefore the Wholesaler needs less collateral to mitigate the financial loss risk of a default. By having a provision in place where less collateral is posted, but the risk of default remains the same, this principle is not upheld.

Solution:

The solution we propose is to simply clarify the wording of Schedule 2E of the Business Terms and add an additional clause requiring the provision of a Parent Company Guarantee.

Definitions (WRC Part 1 Objectives, Definitions and Principles):

Current Credit Rating - the latest credit rating issued by any of the Credit Rating Agencies applicable to the relevant Contracting Retailer or the issuer of any Letter

Credit Support Amount -	of Credit, Guarantee or Surety Bond, (and if applicable the issuer of any Alternative Eligible Credit Support) as appropriate; the amount expressed in pounds sterling to be provided by the Contracting Retailer calculated on a monthly basis in accordance with Section 9.11.3 of the Business Terms (representing the Credit Support Requirement less any applicable Unsecured Credit Allowance and any interest accrued on the cash deposited in the Cash Security Account for that Contracting Retailer);
Unsecured Credit Allowance -	the Unsecured Credit Allowance applicable to the Contracting Retailer in accordance with Section 9.11 and the Schedule 2E Key Terms of the Business Terms;
Minimum Credit Rating -	a minimum credit rating, applicable to an entity which holds such a rating for its long-term unsecured and non-credit-enhanced debt obligations of [BBB-] or higher from S&P or Fitch or [Baa3] or higher by Moody's;
Parent Undertaking -	the meaning given in section 1162 of the Companies Act 2006 as amended (and "parent" shall be construed accordingly); Section 1162 of Companies Act 2006: ... (2)An undertaking is a parent undertaking in relation to another undertaking, a subsidiary undertaking, if— (a)it holds a majority of the voting rights in the undertaking, or ...

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).

Recommendation

We recommend that the wording is amended as follows, new text in blue bold:

2. where (a) a Contracting Retailer ~~and or~~ (b) the Parent Undertaking of a Contracting Retailer, holds a Current Credit Rating, ~~this shall~~**either may** be used for the purposes of calculating or removing any Unsecured Credit Allowance ~~available to the Contracting Retailer. If the entity whose Current Credit Rating is to be used for this purpose~~ **Where it** holds two or more of such ratings, ~~it shall use the lowest rating shall be used~~**provided;**

...

4. (a) where a Current Credit Rating is provided for the Contracting Retailer ~~(by the Contracting Retailer itself or by its Parent Undertaking) or its Parent Undertaking~~ that meets ~~or exceeds~~ the Minimum Credit Rating ~~or above~~ there shall be an allowance of 40% applied to the Credit Support Requirement. ~~Where the Contracting Retailer qualifies for this Unsecured Credit Allowance based on the Current Credit Rating of its Parent Undertaking, the Unsecured Credit Allowance shall be underwritten in full by the Parent Undertaking in the form of a Parent Company Guarantee as outlined in section 9.11.4 (b) of the Business Terms. Where a Parent Company Guarantee is not provided, expires or is removed the 40% Unsecured Credit Allowance will be rescinded immediately and automatically and all provisions and requirements as set out in section 9.11 of the Business Terms will continue to apply;~~ **or**

(b)...

Alternatively, if it is accepted that a Retailer can always use its Parents' Credit Rating through the provision of a Parent Company Guarantee, and that the WRC provides for this at any given time, then there is no need to have the current additional wording in Schedule 2E of the business Terms at all, and simply the recommendation can be for it to be removed so as to revert the drafting back to that which was included in the Statutory consultation.

Principles and Objectives

Principles	Affected (Y/N)	Description
Efficiency	N	
Proportionality	N	
Transparency	N	
Simplicity, cost-effectiveness and security	N	
Barriers to entry	Y	Without the change proposed new entrants without a Parent company may not be able to compete in a like for like manner with Retailers who do have a Parent Company with good credit ratings.
Non- discrimination	Y	This change proposal will reduce the potential for accidental discriminatory treatment of Retailers.
Customer participation	N	
Customer contact	N	
Seamless markets	N	There is a risk that without clarification the interpretation of what level of credit support is required could be disputed between parties.
No limit on upstream competition	N	
Business Terms Objectives	Y	This change proposal will improve clarity in the Business Terms and deliver the Business Terms objectives
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(e), (f) and (g).

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)	Y	Schedule 2E, "Key Terms" (2. and 4.)
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)	N	
Central System	N	
Trading Party systems which interface with Central Systems and other relevant Trading Party systems/ business processes.	N	
Scottish Core Industry Documents	N	

Impact Assessment	
<p>General Comment</p> <p>Pre-go live, consideration of the timing of adoption and implementation of the change may be relevant.</p>	<p>The change is considered to remove possible material impacts on Retail operations and will benefit both wholesalers and Retailers by reducing potential for disputes and driving clarity in the use of parent company credit ratings.</p>
Cost/Benefit Estimate	
<p>Financial Benefit Estimate (Low: < £10K, Medium: £10K To £100K, High: > £100K)</p>	
<p>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(h).</p>	
Further Comments	