

Payment Terms between Retailers & Wholesalers Business Stream response

1 Introduction

Business Stream welcomes the opportunity to provide comment on the “Payment terms between retailers and wholesalers” consultation. Our comments are based on our experience of operating as a retailer in Scotland since 2008 and of how the payment terms put in place for the Scottish market have worked in practice.

We think that the approach taken to setting payment terms in the consultation is sensible, and that broadly speaking they should create an effective means of facilitating market settlement. However, we have a number of concerns over the proposals for how these terms should be implemented. In some cases, such as in setting invoice dates, and excluding standing charges from reconciliation, there are further practical considerations that need to be taken account of. In other areas, we are concerned that the proposals make it possible for the incumbent to offer more favourable terms to their own retail subsidiaries and also to place obstacles in the way of new entrants wishing to switch customers. In addition, we are particularly concerned that the proposed payment period represents a substantial financial benefit to wholesalers, which will reduce the ability of new entrants to compete, unless it is accounted for within the retail margin.

2 Executive Summary

Q1. Is our proposal to set standard terms, but to allow companies to agree to vary these terms, appropriate?

We believe that this proposal (Option 2), as set out in the consultation, would be appropriate, but only if incumbents are barred from negotiating non-standard terms with their own retail subsidiary. It is also essential for all retailers to be able to access the standard terms if desired. If these safeguards are not in place, then the standard terms should apply universally and there should be no negotiation of terms (Option 4), as the only way of guaranteeing a level playing field. The ability to negotiate terms could still then be added at a later date, after the market has matured, as happened in Scotland.

Q2. Are our proposals around publication of non-standard payment terms appropriate?

We agree that these are appropriate, so long as exemptions are only granted by Ofwat in genuinely exceptional circumstances, and that the process for granting these is robust and clearly justifiable.

Q3. Is a settlement period of one day appropriate?

We believe this is the most appropriate period to use, as it has proved to work well in the Scottish market, as well as in other similar utility markets.

Q4. Is it reasonable to apply the same payment terms to all products and services in the markets?

We agree that this makes sense, and that consolidated invoices for all services will reduce the administrative burden of dealing with multiple wholesalers.

Q5. Are the details of the standard payment terms – billing period, payment period and collateral requirements – appropriate?

We are concerned that limiting the standard terms to only those retailers that meet the collateral requirements could act as a significant barrier to entry for smaller new entrants, and have outlined two possible alternatives in our response to Section 4.8. In terms of the payment period, we do not agree with the method of calculation used for debtor days, and have described why below. We also feel that it may be more appropriate to shorten the payment period but to take account of this advantage to wholesalers by increasing the retail margin. Finally, some flexibility will need to be retained until the technical requirements of the market operator are fully defined, as these will have an impact on the production of invoices.

3 Payment Terms Proposals

3. Options For Setting Payment Terms

The options presented offer several proposals for combining the two potential methods for setting payment terms:

1. A standard set of terms that is guaranteed to be available for any customer contract.
2. The ability for retailers to negotiate a tailored set of terms that will best fit their needs for a given contract.

The first of these is essential to the effective operation of the market. The second is potentially a useful feature, but would need appropriate controls to ensure that it is not open to abuse.

In order for retailers to be able to develop a set of services and price options to offer to customers, they must know in advance what payment terms they will receive from the wholesaler. Therefore, it is vital that a standard set of terms should automatically be available on request for any retailer to serve any customer. Without this, retailers will not be able to price their services as competitively as possible, and the need to negotiate terms separately for each customer contract could noticeably increase the complexity and timescales of the transfer process. For this reason, we would not favour Option 1 as described in the consultation.

As noted above, we think the ability to negotiate different terms would be beneficial to the market, but the correct safeguards must be in place to prevent any abuse. Firstly, it should be made explicit that retailers have a default set of terms that are guaranteed to be offered. Terms must only be open to negotiation if both parties are happy to do so; if either disagrees, then the standard terms should automatically apply. This is necessary to prevent incumbents from using their market power to obstruct access to their supplies. Secondly, it is crucial that incumbents are prevented from offering overly generous terms to their own retail subsidiaries. Options 2 and 3 both offer measures to guard against this, but there are downsides in each case. Publication of non-standard terms ensures that these are open to scrutiny, but it puts the onus on others to identify any anti-competitive behaviour, and also may take time to resolve. On the other hand, requiring Ofwat to approve any such terms increases the regulatory burden, and may not be viable if retailers wish to use non-standard terms for a large number of customers. Our preferred alternative would be that incumbents should not be able to offer anything other than the standard terms to their own retail subsidiaries. This would still leave new entrants free to agree terms that work better for both parties while preventing any abuse. WICS have created a similar regime in Scotland, where the incumbent retailer can only use the standard terms of payment in advance, whereas any other company able to provide the appropriate guarantee can choose to pay in arrears.

If this safeguard was included, then we would agree that Option 2 is the most appropriate approach to follow. If not, then we believe that following Option 4 would be the only way to guarantee a level playing field.

4.1 Products and services

Since all payments will be in arrears it makes sense for all charges to be presented in a single invoice, and this will certainly be a significant benefit in managing the range of payment relationships that a retailer may need to maintain. Given the split between water and sewerage services in England, we would also hope that it will be possible for wholesalers to develop more innovative offerings that might allow all services for a single customer to be paid through a single invoice.

4.3 Settlement period

We fully agree with the logic used in this section. As noted, there are currently no water tariffs available to cover periods shorter than a day, and it seems unlikely that this will change in the near future. On the other hand, a settlement period longer than 1 day could have an impact on the ability of customers to switch freely. Consistency with the Scottish market is also a useful feature.

4.4 Billing period and payment period

We do not agree with the approach that has been used in this section to minimise the change to the status quo from the wholesalers' point of view. The industry debtor days' average reflects the amount of time taken by customers to pay their bills after they have been issued, whereas the arrangements proposed here for invoice payments also include an accrual to cover the period when the services are received. This would mean that the wholesaler would on average receive payment 15 days earlier than at present for a monthly billed customer, and 45 days earlier for a quarterly billed one.

In order to take account of this, we think a figure that includes a billing period accrual needs to be calculated to represent the existing payment arrangements, so that this can be equated with the proposals being set out here. This would be more useful than a debtor days figure, since it would take account of the difference in cashflow from monthly and quarterly billed customers.

At the same time, we do not think it would be appropriate to set payment terms with the aim of replicating the current situation as closely as possible. A payment period longer than 1 month would mean that reconciliation settlement runs would be published and invoiced before the original invoice was due, which could lead to confusion over which invoice should be paid. Instead, a shorter payment period would be preferable, but in that case the financial advantage gained by the incumbents as a result of the move to monthly billing periods with shorter payment periods should be reflected in the retail margin available.

4.5 Initial Invoicing

There are 2 main factors that will have an impact on the timing of initial invoices. One is that the market operator will need time to run all settlement reports, carry out any necessary verifications, and supply the reports to all parties. In Scotland, the CMA publishes the R1 run 2 business days after the end of the month, which provides an indicative timing, though given the greater complexity of running reports to cover multiple regions it's possible that the English market operator will need longer than this. For this reason, we feel it would be better to run the reports as soon as possible, rather than allowing extra time for meter reads to be submitted. Since a reconciliation run will take place one month later, any discrepancies will be corrected in good time.

The second factor is the time a wholesaler takes from receiving the settlement details to producing their invoice. This could theoretically be turned round in 1 business day, but it may be more sensible to allow time for all parties to review the data to check that they are in agreement with it.

In connection to this, we think it would be helpful if the rules around settlement runs included set criteria and processes for either party to dispute the amount calculated. A single error, for example an extra digit included in a read for a 7 dial meter, can result in a very large charging discrepancy, in which case it might not be acceptable to wait for the following reconciliation run to correct this. In such cases, it would be sensible for the rules around challenging settlement calculations to be clearly laid out.

4.6 Reconciliation and final settlement

The approach laid out here is sensible, and we agree that 3 settlement runs for each billing period, plus a final reconciliation for the full financial year, is the most appropriate number. As a minor point, we would suggest that it may be better to schedule the final reconciliation later than the 8 months mentioned: an 8 month gap would make it simultaneous with the R3 run for the last month of the year, whereas we have found it useful to have an interval between these to identify any issues needing correction.

We also think it is important for all charges, both volumetric and standing, to be included in each settlement run. If an error is detected, for example in the size of meter being charged for, then we feel it makes sense for the wholesale charges to reflect this as soon as possible, to match the fact that any change in the retail bill would take place immediately. Waiting for the final reconciliation could result in a delay of up to 20 months, and if a substantial refund had to be made to the customer, this could result in cashflow problems for the retailer.

4.8 Collateral requirements

Aligning these requirements with Scotland is a sensible approach, making it more straightforward for any retailer to operate on both sides of the border. It is worth noting, however, that in the Scottish market the collateral requirement did not exist at the outset of the market, and was introduced at a later stage as a “variation” on the standard terms and conditions, which require payment in advance from an escrow account. This ensures that the standard conditions are open to any retailer, while also providing further options to those able to provide evidence of more substantial financial backing.

A further point is that obtaining a guarantee from an investment grade rated company is a significant hurdle for new entrants to overcome. In Business Stream’s own case, we have previously established that it would not be possible for us to obtain such a guarantee, due to our public sector ownership, and we believe that many other retailers looking to enter the industry would also find this a challenge. This could therefore act as a barrier to entry for the market, as any such company would potentially need to negotiate individual terms with the wholesaler for every customer they wanted to serve. This would be a significant administrative burden and would also place them in a weak negotiating position since they would have no default set of terms to fall back on if those offered by the wholesaler were not acceptable. The rules set out in Figure 4 are helpful in outlining the principles to be followed, but still allow for differences in interpretation, which could be time-consuming to resolve and

would introduce too much uncertainty into the process for transferring customers. On top of this, this requirement would likely make the retailer's ongoing payment arrangements more complex to handle, if different terms had to be applied to each invoice being received.

Given the above points, we would suggest that the one of the two following approaches should be taken instead:

1. An escrow account, to be maintained with a strict minimum balance, should be an alternative basic collateral requirement, enabling retailers to obtain the standard payment terms and conditions. This would be similar to the situation in Scotland.
2. A second set of standard terms and conditions should be established, which would be available to retailers using an escrow account, but not able to provide a guarantee.

We would favour the first of these solutions, as having two separate sets of standard terms would seem to add unnecessary complexity to the market, and there would be the challenge of ensuring that neither provided a financial advantage over the other. We feel that an escrow account will provide the same level of protection to wholesalers as a guarantee, and that therefore there should be no reason to distinguish between them.

4 Conclusion

Payment terms are an important building block of the market arrangements, and this consultation provides substantial clarity on what retailers and wholesalers can expect in this area. We have outlined a number of concerns that we think need to be addressed in order to make these proposals more practical and to preserve a level playing field in the market, but we believe that the solutions to these are relatively straightforward, and that they fit well into the overall intentions of Ofwat's proposals. We would be happy to discuss further any of the issues raised in our response.