October 2013

Water today, water tomorrow

Payment terms between wholesalers and retailers – a consultation

www.ofwat.gov.uk

OFWAT

About this document

The purpose of this document is to consult on Ofwat's preferred approach to setting payment terms between wholesalers and retailers in the water and wastewater markets in England and Wales. Following this consultation, we will publish a statement on the form of payment terms.

In 'Setting price controls for 2015-20 – final methodology and expectations for companies' business plans' (the 'methodology statement') we recognised that details of payment terms are needed so that water companies can use the information to construct their business plans. So, we confirmed that:

- retailers should be required to pay wholesalers in arrears;
- there needs to be a consistent billing and settlement period across the non-household market, which should be based on appointed companies' current billing and settlement practices to minimise any impacts on wholesale cash flow and credit risk;
- retail entrants should be subject to proportionate credit requirements and consistent financial checks; and
- the detail on billing, settlement and credit requirements should be proposed by the Open Water programme ('Open Water') by the end of October.

Because Open Water has not produced proposals on the details of payment terms, we are now publishing this consultation. The proposals have been shared with members of Open Water. We are grateful in particular to the members of the Open Water Programme Delivery Board[1], who have given us constructive feedback.

[1] http://www.open-water.org.uk/key-contacts/

Contents

Summary of recommendations

The following is our 'minded to' approach for setting payment terms. We invite views from market participants and stakeholders on whether these terms are appropriate, otherwise we intend to formalise them for the purposes of setting prices in 2015 and defining the non-household market arrangements. For the purposes of water companies' business plan submissions, these terms should be assumed to apply to household and non-household retail price controls.

- We are setting standard payment terms between wholesalers and retailers.
- We recognise that it may, on occasion, be appropriate for parties to agree to vary these terms. In the event that a bilateral agreement is reached that differs from these terms the default position is that these arrangements will be published on the wholesaler's website. This is intended to increase transparency and address level playing field concerns[2]. If a party is concerned that publication could lead to a competitive disadvantage, it may apply to Ofwat for non-publication. Where parties are within the same integrated or group structure, we would be very unlikely to agree to non-publication of payment terms.
- These payment terms will apply to all products and services in the market, regardless of whether settled bilaterally or with the involvement of the market operator.
- The settlement period shall be one day. This does not form part of the payment terms, but is defined alongside as the payment terms and settlement period need to be compatible.
- The standard payment terms are as follows.
    - The billing period is one calendar month.
    - The payment period is the latter of 30 days after the end of the billing period, or 15 days after the invoice is received.

[2] For further discussion of level playing field issues, see 'A level playing field for the water market – a discussion document', Ofwat, September 2013.

- Retailers will need to provide a letter of credit from a guarantor with a minimum investment grade credit rating. If collateral requirements deviate from the standard terms, the following rules must be adhered to:
    - the credit and collateral arrangements offered must be proportionate; and
    - the rationale for credit decisions must be clearly explained in a formalised format.

These terms are consistent with many of the payment terms arrangements found in the Scottish retail market.

Consultation questions

We welcome comments on any of the issues covered in this document, but in particular, we are interested in your responses to the following questions.

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

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

Q3 Is a settlement period of one day appropriate?

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

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

Responding to this consultation

We welcome your responses to this consultation by **28 October 2013**. This consultation period is short so that we can provide a definitive position on payment terms quickly. This will enable water companies to take payment terms into account when they submit their business plans for the 2014 price review to us.

We aim to publish a statement on payment terms shortly after the end of the consultation.

You can email your responses to jacob.wood@ofwat.gsi.gov.uk or post them to:

Markets and Economics Division
Ofwat
Centre City Tower
7 Hill Street
Birmingham
B5 4UA.

If you wish to discuss any aspect of this consultation, please contact Jacob Wood on 0121 644 7539 or by email at jacob.wood@ofwat.gsi.gov.uk.

We will publish responses to this consultation on our website at www.ofwat.gov.uk, unless you indicate that you would like your response to remain unpublished. Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FoIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004.

If you would like the information that you provide to be treated as confidential, please be aware that, under the FoIA, there is a statutory 'Code of Practice' which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain why you regard the information you have provided as confidential. If we receive a request for disclosure of the information, we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on Ofwat.

1. Introduction

1.1 Background

Payment terms are important for water companies' business plans for the 2014 price review (PR14) because they affect the working capital requirements for wholesale and retail. Payment terms are also important for the development of retail markets as they can act as a barrier to retail market entry and affect the risks that both wholesalers and retailers face.

The detail of payment terms is needed this month to inform companies' assumptions before they submit their business plans in December. The payment terms assumption will be the same for their household and non-household retail activities.

In 'Setting price controls for 2015-20 – final methodology and expectations for companies' business plans' (the 'methodology statement') we confirmed that:

- retailers should be required to pay wholesalers in arrears;
- there needs to be a consistent billing and settlement period across the non-household market which should be based on appointed companies' current billing and settlement practices to minimise any impacts on wholesale cash flow and credit risk;
- retail entrants should be subject to proportionate credit requirements and consistent financial checks; and
- the detail on billing, settlement and credit requirements should be proposed by Open Water by the end of October.

This consultation sets out our 'minded to' proposals on payment terms, including the details of billing, settlement and credit requirements.

1.2 Objective

The purpose of this paper is to assess and recommend:

- how prescriptive the setting of payment terms for the markets will be;
- what products and services the payment terms will apply to;

- what the billing period will be – the period of time over which charges are amassed;
- what the payment period will be between retailers and wholesalers – how long the participant receiving goods has to pay for them;
- what credit requirements will be associated with the payment terms; and
- what the settlement period will be.

2. Assessment criteria

In order to assess the payment terms options we have used the assessment criteria that have been endorsed by Open Water's High Level Group (HLG). We consider these to be appropriate criteria against which to assess the options as they reflect the needs of the industry and our duties[3].

Details of the assessment criteria (AC) are included in appendix 1. In brief, these criteria are:

- **assessment criterion 1** – ensures the efficient discharge by licensees and appointed companies of the obligations imposed upon them by their licence;
- **assessment criterion 2** – promotes the efficient, economic and co-ordinated operation of the water and wastewater sector;
- **assessment criterion 3** – promotes effective competition in the sector's contestable markets wherever appropriate;
- **assessment criterion 4** – promotes customer participation in the market; and
- **assessment criterion 5** – promotes efficiency in the implementation and administration of market facilitation activities.

We have considered explicitly how options affect the creation of a level playing field through criterion 3 and how future arrangements for upstream markets could be affected through criteria 1 and 2.

The scope for our involvement varies with each of the options set out in this document. So, in our consideration of each option we have highlighted the regulatory burden. This sits under criteria 2.

[3] Ofwat is formally represented on the HLG along with the water sector, customers and the UK and Welsh Governments.

3. Options for setting payment terms

The first question that needs to be answered is how prescriptive should the payment terms be? The options range from having firm payment terms that must always apply through to giving companies guideline standard terms for starting negotiations but otherwise leaving the decision up to market participants.

We have already ruled out the option of not giving any guidelines on payment terms in the methodology statement. So in this chapter, we only assess options with different levels of prescription.

3.1 Options

Table 1 below sets out the billing period and payment period in other utility sectors and jurisdictions. In particular, it lists the billing period of water (Scotland), electricity grid trade (GB), gas transporters (GB) and local loop telecoms (GB) with an assessment of their benefits and disadvantages.

Table 1 Payment arrangements in other sectors

<table>
<tr><th>Sector</th><th>Settlement period</th><th>Billing period</th><th>Payment period</th><th>Credit and collateral</th><th>Benefits/ opportunities</th><th>Disadvantages/ risks</th></tr>
<tr><td rowspan="2">Scottish Water</td><td rowspan="2">One day</td><td>One month is set by the Water Industry Commission for Scotland (WICS) as the basis for negotiation.
Final term is settled by bilateral negotiation with WICS' consent.</td><td>The basis is ten days before the start of a billing period.
Final term is settled by bilateral negotiation with WICS' consent.</td><td>A guarantee can be used as an alternative to pre-payment. A guarantor must have a minimum investment grade credit rating.
Payment date for provisional monthly charge is negotiable with Scottish Water.</td><td rowspan="2">A clearly defined basis for negotiation reduces new entrant's cost to negotiate with every wholesaler.
Bilateral negotiation allows market participants to reach an agreement meeting their specific business needs.
The requirement of the Commission's consent for any amendments can prevent potential harms.</td><td rowspan="2">Regulatory burden may be high if the volume of consent requests is large.</td></tr>
<tr><td colspan="3">In practice, payment terms that have been agreed by Scottish Water are the same for all companies. This is because Scottish Water has an obligation from the Water Services Act not to discriminate and this has been enacted by giving all companies the same payment terms.</td></tr>
</table>

Sector	Settlement period	Billing period	Payment period	Credit and collateral	Benefits/ opportunities	Disadvantages/ risks
Electricity – GB (commodity)	30 minutes	One month is set by the Future and Options Association as the basis for negotiation. Final term is settled by bilateral agreement.	The basis is ten days in arrears, or five days after the receipt of invoice, whichever is the latter. Final term is settled by bilateral agreement.	Recently consulted on increasing transparency of payment terms. Credit needs to be posted in the form of cash or a very restricted letter of credit (ie, limited in form and restricted by bank).	A clearly defined basis for negotiation reduces new entrant's cost to negotiate with every wholesaler. Bilateral negotiation allows market participants to reach an agreement meeting their specific business needs.	Bilateral negotiation may leave retail entrants in a disadvantaged position compared with the retail service of a regulated wholesaler.
Gas transporters – GB	One day	One month is set by the Joint Office of Gas Transporters as the basis for negotiation. Final term is settled by bilateral	The basis is 20 days in arrears, or 12 days after invoice was deemed to be received, whichever is the latter. Final term is	Either an adequate credit rating, or a guarantee from a parent that does have such a rating, or a guarantee from a third party such as a letter of credit from a bank.	A clearly defined basis for negotiation reduces new entrant's cost to negotiate with every wholesaler. Bilateral negotiation allows market participants to reach an agreement meeting	Bilateral negotiation may leave retail entrants in a disadvantaged position compared with the retail service of a regulated wholesaler.

Sector	Settlement period	Billing period	Payment period	Credit and collateral	Benefits/ opportunities	Disadvantages/ risks
		agreement.	settled by bilateral agreement.		their specific business needs.	
Telecoms local loop – GB	BT will apportion rental on a daily basis for the initial period if that initial period is less than a month.	Monthly or quarterly.	30 days after the date of the invoice.	BT may require the operator to pay a deposit or provide a guarantee as security for payment of future charges. The amount is calculated based on BT Wholesale Credit Vetting Policy.	Payment date depends entirely on date of issue of invoice, which maximises incentive to deliver invoice promptly.	Longer billing period results in greater variation in cash balances as cash flow more lumpy.

We have already confirmed certain aspects of payment terms (such as that payment will be in arrears). Because of this, we have ruled out the option of 'no prescription of payment terms'. Below, we set out four options for prescribing payment terms.

3.1.1 Option 1 – a combination of standard terms and bilateral negotiation

Standard terms of billing period, payment period and collateral requirements could be set in market codes. The standard terms would serve as a reference point, and wholesalers and retailers are allowed to reach an agreement of different terms in a bilateral negotiation. Our consent would not be required if market participants make any amendments to the standard terms. Under this option, there is no requirement for companies to offer the standard terms – they are simply a starting point for negotiation.

Setting standard terms would ease the negotiation process if the standard terms could meet market participants' business needs and so reduce the retailers' costs to negotiate with all wholesalers. It would also give market participants the flexibility to move away from the standard terms and reach a bilateral agreement to meet their specific business needs.

But because there is no requirement for us to consent to amendments or transparency of payment terms, there is a risk that a regulated wholesaler could abuse its dominance to raise the barriers to entry. Of course, in this case, we would still be able to use our ex post powers under the Competition Act 1998 (CA98) to curtail and punish anti-competitive behaviour.

3.1.2 Option 2 – standard terms, with publication of any agreed non-standard terms

Standard terms for billing period, payment period and collateral requirements would be set in market codes. Wholesalers and retailers would by default use these standard terms.

On occasion, it may be appropriate for parties to agree non-standard terms bilaterally – for example, to allow an entrant to try an innovative service with customers or, alternatively, if a counter-party represents a significant credit risk. To increase transparency and to encourage self-regulation of the market, wholesalers will need to publish any agreed non-standard payment terms on their websites.

In exceptional cases, if companies can demonstrate that publishing their payment terms would create a significant competitive disadvantage for them, then a request could be made to Ofwat for payment terms not to be published.

Setting standard terms would simplify the market arrangements. If specific business circumstances require, wholesalers and retailers could agree different terms bilaterally.

Requiring companies to publish any non-standard payment terms increases transparency and encourages the sector to self-regulate – that is, to ensure that agreed payment terms are not anti-competitive. We would still be able to use our ex post powers under the CA98 to curtail and punish anti-competitive behaviour.

Allowing companies, in exceptional circumstances, to request not to publish their payment terms is intended to avoid reducing their ability to offer innovative products. But we expect this would only occur in exceptional circumstances, and we could refuse a request for secrecy. Where parties are within the same integrated or group structure, we would be very unlikely to agree to non-publication of payment terms.

3.1.3 Option 3 – a combination of base case, bilateral negotiation and Ofwat consent

Standard terms for billing period, payment period and collateral requirements could be set in market codes. Wholesalers and retailers have the option to use the standard terms or agree alternative terms bilaterally. But any non-standard terms would require Ofwat's approval.

Setting standard terms would ease the negotiation process as long as the base case could meet market participants' business needs and so reduce the retailers' costs to negotiate with all wholesalers. And if specific business circumstances require, wholesalers and retailers could enter a bilateral negotiation to reach an agreement of different terms.

Requiring Ofwat's consent for any amendments could prevent regulated wholesalers from abusing their dominance and ensure a level playing field. But it would increase the level of regulator involvement in the process.

3.1.4 Option 4 – setting firm terms

Under this option, the payment terms could be set definitively in market codes (‘firm terms’). For example, all companies could be required to have a billing period of one calendar month and retailers would have to make the payments in the 30 days following the last day of each billing period.

Firm terms would remove all the costs related to negotiations and any potential discrimination against new entrants. But this approach might stifle innovation in the market – there are a variety of services and products in the market, so one solution may not fit all the business needs. It may be the case that alternative approaches may be appropriate for different products, and so setting firm terms for all products could be inappropriate.

3.2 Assessment of options

In table 2 below we assess each of the options with a score against the five assessment criteria we set out in chapter 2.

- A ‘High’ score suggests the option fully meets the criterion.
- A ‘Medium’ score suggests the criterion is partially met.
- A ‘Low’ score means the criterion is not met.

Table 2 Assessment of options for setting payment terms

Options	AC 1 – efficient discharge of obligations	AC 2 – efficient, economic and co-ordinated operation	AC 3 – effective competition	AC 4 – customer participation	AC 5 – efficient implementation
Option 1 – standard terms and bilateral negotiation	**High** Participants can tailor terms to meet their specific working capital requirement and credit risk.	**Medium/High** Participants can tailor terms to meet their specific working capital requirement and credit risk, but wholesalers may abuse their dominant position. Terms between retailers and wholesale entrants could be tailored to meet wholesale entrant needs. No regulatory burden on Ofwat. If billing period is configurable, impact on cost of market operator	**Medium** Participants can tailor terms to meet their specific working capital requirement and credit risk, but wholesalers may abuse their dominant position and create un-level playing field.	**Medium** Customer participation promoted through level of effective competition.	**Medium** There is a cost of conducting bilateral negotiation and outcome is not transparent. Increased reliance on ex post regulation.

Options	AC 1 – efficient discharge of obligations	AC 2 – efficient, economic and co-ordinated operation	AC 3 – effective competition	AC 4 – customer participation	AC 5 – efficient implementation
		(MO) systems.			
Option 2 – standard terms, with publication of any agreed non-standard terms	**High** Participants can tailor terms to meet their specific working capital requirement and credit risk.	**High** Participants can tailor terms to meet their specific working capital requirement and credit risk. Publishing terms will enable self-regulation, reducing the risk of wholesalers abusing their dominant positions. Terms between retailers and wholesale entrants could be tailored to meet wholesale entrant needs. Ofwat's role limited to cases where companies consider there is a genuine case for a lack of	**High** Participants can tailor terms to meet their specific working capital requirement and credit risk. Publishing terms will enable self-regulation, reducing the risk of wholesalers abusing their dominant position.	**High** Customer participation promoted through level of effective competition.	**Medium/High** There is a cost of conducting bilateral negotiation. Outcome is transparent.

Options	AC 1 – efficient discharge of obligations	AC 2 – efficient, economic and co-ordinated operation	AC 3 – effective competition	AC 4 – customer participation	AC 5 – efficient implementation
		transparency. If billing period is configurable, impact on cost of MO systems.			
Option 3 – standard terms with Ofwat consent of non-standard agreements	**High** Participants can tailor terms to meet their specific working capital requirement and credit risk.	**Medium** Participants can tailor terms to meet their specific working capital requirement and credit risk. The regulator can safeguard against wholesalers abusing their dominant position in the negotiation. Terms between retailers and wholesale entrants could be tailored to meet	**High** Participants can tailor terms to meet their specific working capital requirement and credit risk. The regulator can safeguard against wholesalers abusing their dominant position and so create a level period.	**High** Customer participation promoted through level of effective competition.	**Medium** There is a cost of conducting bilateral negotiation. Outcome is transparent to regulator but not market. There is a cost of providing regulatory oversight.

Options	AC 1 – efficient discharge of obligations	AC 2 – efficient, economic and co-ordinated operation	AC 3 – effective competition	AC 4 – customer participation	AC 5 – efficient implementation
		wholesale entrant needs. Ofwat needs to review amendments – increases regulatory burden. If billing period is configurable, impact on cost of MO systems.			
Option 4 – firm terms	**Low** No flexibility to amend the billing period to meet specific business needs.	**Medium** No flexibility to amend the billing period to meet specific business needs. Terms between retailers and wholesale entrants could be tailored to meet wholesale entrant needs. No regulatory burden on Ofwat. Reduces need for flexibility in MO systems.	**Medium** Reduce new entrants' transaction costs of negotiation, but no flexibility.	**Medium** Customer participation promoted through level of effective competition.	**High** Fully transparent administration. No ongoing regulatory costs.

3.3 Recommended option

Our preferred approach is **option 2** (that is, to set standard terms, with publication of any agreed non-standard terms).

This option sets standard terms that we would expect market participants to use. But, on the occasions on which alternative arrangements may be more appropriate, companies can agree these bilaterally. Requiring wholesalers to publish their any non-standard payment term agreements will encourage them to self-regulate and so limit the wholesalers' dominance in the bilateral negotiation. And it promotes effective competition in retail markets.

This option also meets all of the assessment criteria and outperforms in all of them, except on efficient implementation. It strikes an acceptable balance between establishing a level playing field while enabling flexibility for market participants and minimising the regulatory resources needed.

We have considered whether there would be merit in limiting the flexibility of market participants to negotiate on the billing period. Eliminating this flexibility would simplify the systems that the market operator needs to build in order to accommodate different payment terms. But, on reflection, we consider that this additional cost is outweighed by the benefit of allowing companies flexibility to negotiate their payment terms.

4. Standard payment terms

In order to set out the standard payment terms, we first need to consider what products and services the payment terms will apply to. This is considered in section 4.1 below. Section 4.2 then sets out the indicative settlement timeline, of which payment terms will form a part. The following sections then expand on each aspect of the settlement timeline.

4.1 Products and services

Broadly, charges for products and services in water and wastewater fall into the following three categories.

- Continuously delivered services – charged by measurement (for example, metered potable water).
- Continuously delivered services – standing charge (for example, charge for having a meter of set size).
- Event-based charges (for example, charge for replacing a meter).

Payment terms for different products are different in the Scottish market, so we have considered whether it is appropriate to apply the same set of payment terms to all products and services in the market. We consider that having the same payment terms for all products and services is appropriate.

In the Scottish water market there is a distinction between the payment terms for ‘primary’ charges and ‘non-primary’ charges. The payment terms described in table 1 for Scotland are for primary charges – that is, measured and standing charges for continuously delivered services (water, wastewater, trade effluent and surface water drainage).

Non-primary charges in Scotland consist of site works and other transactional charges. Scottish Water issues invoices for these charges twice a month. This occurs in the middle and at the end of the month. The payment period is then ten working days after the invoice is issued. This results in these products being paid for in arrears. The exception to this is water and wastewater connections for household properties that are billed for in advance.

It has already been confirmed that payment will be in arrears in England and Wales. Because of this, the volume of services provided that use event-based charges will be known at the same time as continuous services charges are calculated. Because of this, event-based charges can be calculated and invoiced at the same time as charges for continuously delivered products and services. In Scotland, non-primary charges cannot be invoiced at the same time as primary charges because primary charges are paid in advance, at which point the number of ‘events’ is not known.

Given that invoicing for event-based charges can be carried out at the same time as for other charges, it is logical to set other aspects of the payment terms on the same basis. Doing so will allow a wholesaler to issue a single invoice that covers all products and services provided to a retailer. This will simplify the payment relationships that retailers and wholesalers will need to manage. This will be more important in the markets in England and Wales as retailers will need to interact with a number of wholesalers if they operate in more than one wholesaler’s area. Similarly, wholesalers may need to interact with several retailers.

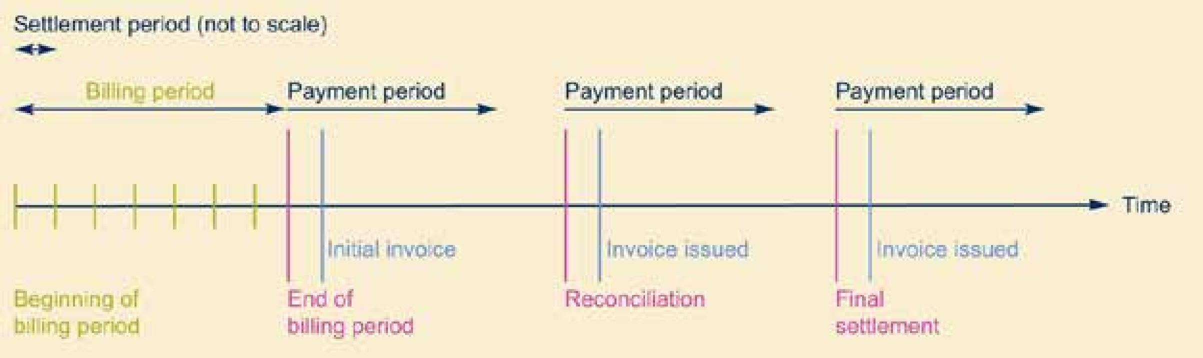
We consider that these payment terms should apply to all products and services in the market, and not just those for which the market operator calculates charges. Having the same payment terms across centrally and bilaterally settled products and services will help create a level playing field for all market participants.

4.2 Settlement timeline

In order to decide on the most appropriate standard payment terms, an indicative settlement timeline is needed so that we can determine what payment terms would be appropriate to the sector.

Figure 1 below sets out an indicative settlement timeline. In the rest of the chapter, we explore how each of the components of the timeline should be set. Definitions of the components on the timeline are included in the glossary (in appendix 2).

Figure 1 Indicative billing and settlement timeline



4.3 Settlement period

The settlement period is the minimum period for which traded services (for example, potable water supply) can be purchased.

It would add unnecessary complexity to have a billing period that was shorter than the settlement period. So, the length of the settlement period needs to be defined before the billing period.

In the Great Britain (GB) electricity sector the settlement period is 30 minutes. In the GB gas sector and the water sector in Scotland it is one day. The two are different because of the physical nature of the goods.

It is useful to have a short settlement period for electricity as this allows markets to dispatch generation more efficiently as demand fluctuates over the day. In contrast, in gas changes in demand over the course of a day can be met to a greater extent by the network itself – through changes in 'line pack' pressure in the pipes and storage on the distribution network. So, the value of having a shorter settlement period is lower, which means that a daily settlement period is more appropriate.

In water, 'time of use tariffs' for consumption are not common place. Those tariffs that do currently exist that consider time of use do not require a shorter settlement period than a day to operate. For example, Anglian Water's tariff for users with demand of more than 10 megalitres (Ml) contains a 'maximum daily demand' component, which is a charge for the level of demand on the highest use day.

In the event that time of use tariffs were to become more prevalent, it may be advantageous to move to a more granular (for example, hourly) settlement period. But this is not necessary at the moment.

A settlement period longer than a day would reduce the flexibility to develop trading for day periods in the wholesale markets. As these have not yet been developed, it would be unwise to rule out daily trading at this point.

Settlement periods of longer than a day would also add complications for switching as allocation of charges would be more difficult if a customer were to switch part way through a settlement period.

If less granular trading becomes the norm, a shorter settlement period of a day would not cause issues as ‘blocks’ of more than one settlement period can be traded together. (For example, in electricity four-hour blocks, day blocks and month blocks are all commonly traded.)

Water and wastewater are more akin to gas than electricity because of their physical nature. So, on the basis of the experience in these markets we propose to set a one-day settlement period in water and wastewater. This will be consistent with the water market in Scotland.

Our working assumption is that the settlement period will be defined as a calendar day (from midnight to midnight).

Because of the effects of British Summer Time, the settlement period of a day will not always be the same length. How this is dealt with is a detailed design issue.

4.4 Billing period and payment period

The billing period is the period of time that is charged for each time an invoice is issued. To avoid having to divide the charge for a settlement period across bills, the billing period will be defined as a discrete number of settlement periods.

We have considered the question of an appropriate billing period and payment period together, as the two combined impact on the number of days on average the retailer will be in debt to the wholesaler.

As payments will be made in arrears to avoid creating a barrier to entry for retailers, a sensible objective for setting the billing and payment periods is to minimise the impact of this on the wholesalers. So, we have considered how best to minimise the change from the status quo in terms of the number of days between the wholesaler supplying the service and the wholesaler being paid for the service.

The time between providing the service and being paid for the service is described as customer debtor days. We have assessed the debtor days for non-household customers across companies using historic data from the June returns. This shows that the average debtor days was 43 days in 2006-07, falling to 40 days in 2010-11. But there is considerable variation in non-household debtor days between companies, from 9 to 80 days in 2010-11.

So, to minimise the change in cash flows for the wholesaler from the current situation we need to set a combination of billing period and payment period that results in the equivalent of a 40-45 debtor day period. Doing this will result in a rough balance (at a sector level) between the wholesalers' payable and receivable trade accounts.

Debtor days is the average number of days that a debt is outstanding. For example, at the end of a 30-day billing period, debt for the first day will have been outstanding for 30 days, and debt for the last day will have been outstanding for no days. On average for the billing period, debt will have been outstanding for 15 days. So, by the end of a 30-day payment period, the debt would have been outstanding for 45 days. This is shown in figure 2 below.

Figure 2 Relation between debtor days, billing period and payment period

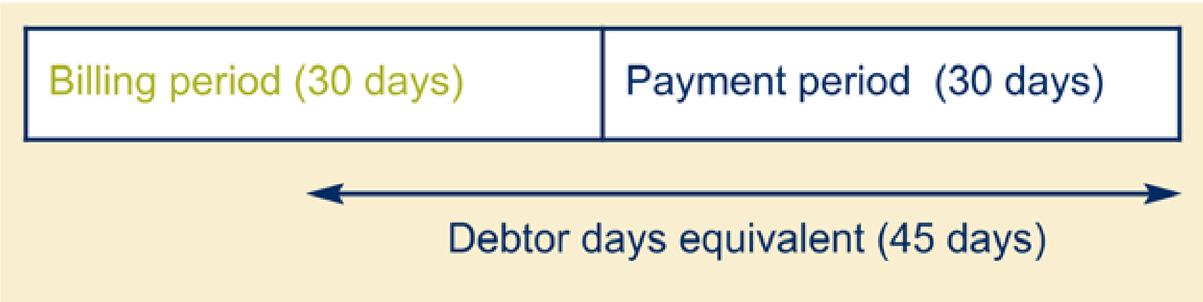


Table 3 below gives three combinations of billing periods and payment periods that achieve this.

Table 3 Billing period/payment period combinations to give 45 debtor days equivalent

	Billing period	Payment period
Option 1	1 day	45 days
Option 2	One month	One month
Option 3	Two months	15 days

It is important to note that the billing period necessarily dictates the frequency of settlement. If the billing period is one month, then an invoice will need to be issued each month. If the billing period is one day, then a bill will need to be issued each day.

So, shorter billing periods increase transaction costs as more bills will have to be issued and processed. While this may not have a significant impact on large retailers, this increased cost could act as a barrier to entry for smaller retailers (including new entrants). A daily billing period also adds complexity as weekend day bills will still need to be issued and processed on weekdays.

But the longer the billing period, the greater the fluctuations in cash balances for both wholesalers and retailers, and the greater the fluctuations in demand for shadow settlement and reconciliation activities.

A pragmatic balance needs to be struck between the two. An assessment of other sectors suggests that a billing period of a calendar month would be appropriate. This is the base case billing period for the GB electricity and gas sectors, and the water sector in Scotland.

In order to achieve the 45 debtor days equivalence, this implies that a standard payment period of 30 days would be appropriate as with monthly billing periods, on average debt will be 15 days old at month end.

An important point of detail is that the payment period should not be restricted by the failure of one party to issue an invoice to the other. So, we propose that the payment period be 30 days from the last day of the billing period, or 15 days after the invoice is deemed to be received, whichever is the later. This is based on the precedent in the energy sector for allowing approximately half of the length of the payment period to pay if the invoice is received late.

4.5 Initial invoicing

The initial invoicing of a billing period should happen as close to the end of that billing period as possible to give the maximum time between invoicing and when the payment must be made. But it is also beneficial to allow some time for daily reads of meter data for the billing period (which large customers may have) to be processed before the invoice is issued.

So, we propose that the initial invoicing should happen five working days after the end of the billing period.

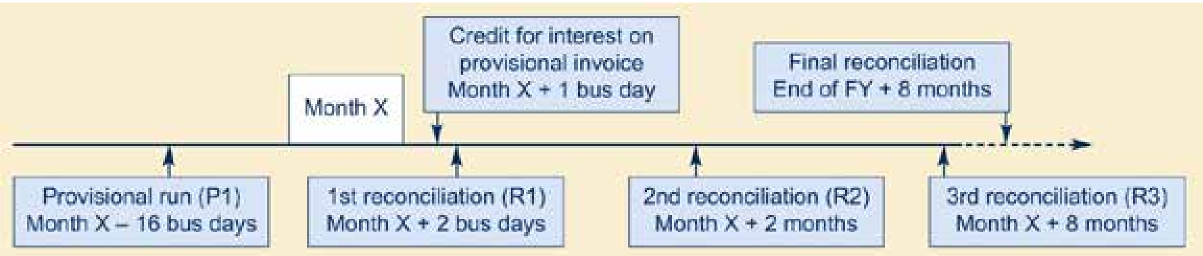
Note that, as the payment period is defined from the end of the billing period, this does not affect the average age of debt.

4.6 Reconciliation and final settlement

Reconciliation is the process of resettlement to take account of the fact that as more meters are read over time, more information will be available about actual consumption over the billing period. The difference between estimated consumption on which the initial invoice is based and actual consumption will result in a recalculation of charges, and this difference will then need to be paid between the wholesaler and retailer.

The reconciliation period needs to be long enough for meter readings to feed through for most non-household customers. This will enable reconciliation to reflect actual consumption as far as it can be known. Currently, there are no sector-wide standards for minimum meter reading frequency in England and Wales. It may be that having a common standard would be advantageous for competition.

Figure 3 Settlement timeline for primary charges for water in Scotland



In the Scottish water market the initial settlement of primary charges happens 10 days in advance of the billing period. Reconciliation, or resettlement, then occurs four times (including final reconciliation).

- The first time is immediately following the billing period.
- The second time is two months after the billing period.
- The third time is eight months after the billing period.
- Final settlement follows by the end of the financial year after the year in which the billing period occurred.

In Scotland, the timings of these resettlements and final settlement were driven by the fact that meters were read twice a year, and so by the third resettlement, most meters would be read.

Our initial view is that a meter reading frequency of every six months may be an appropriate standard for England and Wales. If this was adopted, then reconciliation could follow a similar pattern to Scotland, with:

- an initial reconciliation three months after the end of the billing period;
- a second reconciliation eight months after the billing period; and
- the final reconciliation eight months after the end of the financial year containing the billing period.

It should be noted that as payment will be in arrears in England and Wales, the initial bill is equivalent to the first resettlement (R1) in the Scottish market, and so one fewer resettlement is needed.

This consideration of the settlement timeline is indicative, and is not being set here as there are broader issues that need to be considered before setting (or otherwise) a standard meter reading frequency and hence the full resettlement timeline. Open Water will consider these issues in its market design process.

Note that we consider this indicative settlement timeline is appropriate for products and services that are charged on a measured basis – and so will need reconciliation for updated or more accurate data. For products and services charged on a standing charge basis or on an events basis multiple reconciliations should not be necessary as the initial charge calculation should be on actual, rather than estimated data. So, these charges could be limited to an initial invoice and a final reconciliation for error correction purposes, which could be aligned with the first reconciliation for other charges.

4.7 Objections

Market participants will be able to object to the charges in their invoices if they consider there is an error. The process for this is a detailed design question that is not addressed here.

4.8 Collateral requirements

As retailers will pay wholesalers in arrears, wholesalers are at risk if the retailer defaults on its payments. A standard means of addressing this issue is for companies to require some form of collateral against the risk of default. This can take the form of:

- cash;
- a letter of guarantee (from parent or bank); and/or
- an investment grade credit rating.

Collateral requirements are also an area in which retailers may be able to innovate. For example, some small suppliers (retailers) in energy have used Renewable Obligation Certificates (ROCs) as an alternative form of collateral (Ofgem, 2010).

But as well as protecting companies from default, credit requirements can also act as a barrier to entry. By setting collateral requirements in excess of what is needed to protect against the genuine risk of default, wholesalers could inhibit market entry.

For the proposals on collateral requirements to be consistent with the rest of the proposed payment terms, we need to propose an appropriate level of credit/collateral requirements. But identifying an appropriate credit requirement is very difficult. It is not possible to produce meaningful analysis without detailed information about the risks associated with trading with different companies.

Instead, as sector regulators in energy, telecommunications and water in Scotland have all grappled with this issue in the past, we consider it is appropriate to use the credit terms that they set out in the standard terms.

In water in Scotland, a letter of credit from a guarantor with a minimum investment grade credit rating is needed for a retailer to deviate from payment in advance.

So, we propose that the same requirement will be used in the standard payment terms in England and Wales. The retailer will need to have a letter of credit from a guarantor with a minimum investment grade credit rating.

Setting this as the standard terms for collateral requirements is intended to align conditions in England and Wales with Scotland. In Scotland, any company that can demonstrate this level of credit worthiness can pay in arrears. Similarly, we would expect companies that cannot demonstrate this level of credit worthiness in England and Wales would negotiate alternative payment terms – including payment in advance.

Also, to reduce the risk of credit requirements creating a barrier to entry, we consider that additional safeguards may be needed to ensure that deviations from the standard terms are appropriate.

Ofgem has considered a number of options to address this issue and has recently closed a consultation on proposed rules to address this (Ofgem 2013). In the consultation, it concluded that the most proportionate approach is to place a requirement on wholesalers to:

- offer proportionate credit and collateral arrangements: and
- explain clearly the rationale for credit decisions.

Given that considerable market experience has led to the development of these rules, it seems prudent for the water sector to adopt a similar approach as it moves towards increased levels of retail competition. Figure 4 below sets out the rules on credit and collateral requirements as proposed by Ofgem but with the sections underlined added to reflect Ofwat's role.

So, we propose that when negotiating payment terms, wholesalers must follow the rules as set out in figure 4.

Figure 4 Proposed credit and collateral requirements rules for licensees (adapted from section A4 of 'Figure 6: Supplier Market Access – detailed rules'[4])

Licensee must offer proportionate credit and collateral arrangements.

Credit terms will be considered to be proportionate when the following conditions are met:

- In reaching its decision, the licensee follows a process which takes into account the individual circumstances of a counterparty, through consideration of a range of relevant information
- The credit terms are a reasonable reflection of the risks of trading with the counterparty.

Licensee must also clearly explain the rationale for credit decisions.

When responding to a request for a trading agreement, the licensee must complete a Credit Transparency Form which justifies its credit decision. This must set out:

- The credit terms and collateral arrangements offered
- The quantitative and qualitative factors and information taken into account in making this assessment
- Any steps the counterparty could take which could result in a material improvement in the credit terms offered.

The licensee must share the Credit Transparency Form with the counterparty and be prepared to discuss it.

These credit forms should be held on file for Ofwat audit for three years.

[4] 'Wholesale power market liquidity: final proposals for a "Secure and Promote" licence condition', Ofgem, June 2013.

5. Next steps

Following the end of this consultation, we will publish a statement confirming our final position on payment terms. This should be used by water companies to form the basis for their assumptions on payment terms for household and non-household retail in their business plan submissions.

Appendix 1: Assessment criteria

Open Water's High Level Group (HLG) has endorsed a common set of criteria that will provide a consistent and robust analytical framework to inform all decisions relating to the design and development of the retail market in order to ensure design choices deliver the best outcome for customers.

As these criteria relate directly to our primary duties, we consider that they are appropriate for assessing the options presented in this consultation.

The assessment criteria for the analytical framework are as follows.

Assessment criterion 1 – ensures the efficient discharge by licensees and appointees of the obligations imposed upon them by their licence.

This includes:

- ensuring that arrangements do not inappropriately impose inefficiencies, costs and/or credit risks that might disproportionately impact on participants' recovery of costs from customers or ability to attract and retain investment.

Assessment criterion 2 – promotes the efficient, economic and co-ordinated operation of the water and wastewater sector

This includes:

- ensuring that the retail market arrangements do not dis-incentivise the promotion of efficiency across the less contestable parts of the value chain; and
- ensuring arrangements are adaptable to changing circumstances, including the development of wholesale markets, potential extension of the market to Wales and any decisions relating to the Scottish market.

Assessment criterion 3 – promotes effective competition in the sector's contestable markets wherever appropriate

This includes:

- minimising barriers to entry and exit for market participants (both in terms of information asymmetries and financial and non-financial costs, such as entry requirements and processes);
- ensuring that a level playing field is created in all of the sector's contestable markets. This includes ensuring that new entrants and incumbents are treated equally and not (dis)advantaged by market design and/or their position or dominance in the wider value chain (for example, an incumbent company's continued role as supplier to household customers and as the wholesaler and network provider);
- minimising the transaction costs of operating within the market, which could give rise to barriers to entry; and
- encouraging and enabling efficiencies and innovation in services.

Assessment criterion 4 – promotes customer participation in the market

This includes:

- ensuring customers can easily identify and compare retailers' service offerings, and elect to switch should they wish;
- minimising barriers to customers switching retailer;
- promoting customer confidence in the market, including through appropriate privacy and security of customer data; and
- avoiding unnecessary barriers to interaction with the Scottish retail market.

Assessment criterion 5 – promotes efficiency in the implementation and administration of market facilitation activities

This includes:

- maximising transparency and efficiency in the delivery of new, centralised facilitation arrangements, including introducing competition into the delivery of these activities wherever appropriate.

Appendix 2: Glossary of terms

Billing period: The period, consisting of one or more settlement periods that are charged for in one bill.

Collateral requirement: The required collateral (securities, cash, etc) that a borrower pledges to demonstrate their ability to meet their obligations to pay for services delivered. The collateral serves as protection for a lender against a borrower's risk of default.

Final settlement: The final reconciliation for a billing period. Once the final settlement has been completed, no more reconciliations can be made for a billing period.

Initial invoicing: The date on which the first bill is issued by one party to another for a billing period.

Payment terms: The complete set of terms that define when and how payments are made between two parties.

Payment period: The length of time after the billing period in which the retailer must pay the wholesaler for services provided within the billing period.

Reconciliation: The issuing of subsequent invoices for a billing period. This is done to correct discrepancies or to reconcile for differences between forecast and actual consumption data.

Settlement period: The minimum time period block over which agreements can be made for the sale and purchase of the commodity.

Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

Phone: 0121 644 7500
Fax: 0121 644 7699
Website: www.ofwat.gov.uk
Email: mailbox@ofwat.gsi.gov.uk
October 2013

ISBN 978-1-908116-44-4

Any enquiries regarding this publication should be sent to us at mailbox@ofwat.gsi.gov.uk.

This document is also available from our website at www.ofwat.gov.uk.