

The effects on counterparty credit risk of potential Retail Household competition in the English water sector: issues and mitigation mechanisms

Terms of Reference

1. Introduction

All appointed Water and Sewerage companies (“WaSCs”) and Water-only companies (“WoCs”) in England currently provide both Wholesale and Retail services to both household and non-household customers. Currently, competition within the water retail sector in England is limited to around 27,000 businesses customers using more than 5 Ml of water per annum, who are able to choose their water (but not sewerage) retailer. In April 2017 competition is set to be extended to allow all non-household customers to change their water and/or sewerage retailer, aligning England with the position in Scotland today.

The Treasury recently set out plans to begin the transition to full household retail competition before the end of the current Parliament (May 2020).¹ The proposal has little detail, but sets out a plan for Ofwat to carry out an assessment of the costs and benefits of extending retail competition to household customers by Summer 2016.

There are a range of options for how such competition might be introduced. To the extent that it is introduced in a way that introduced significant additional risk to incumbent suppliers, it could lead to a material increase in their costs of capital which would ultimately lead to higher customer bills, unless suitable measures were put in place to mitigate this risk. One form that this risk might take could be a material increase in perceived or actual counterparty credit risk.

Rating agencies have already identified increasing counter-party credit risk as a key issue. Moody’s, for example, has identified that the extension of competition into a sector that to date has been a vertically integrated monopoly will invariably increase business risk:

*“Exposure to potentially small and less well capitalised counterparties as new entrants provide retail services and act as the main cash collection agent for the regulated water revenues will increase counterparty risk”.*²

Proper evaluation and consideration of both the potential for an increase in counterparty risk, and measures to guard against and/or prevent such a risk materialising in practice are, therefore, components of a wider cost benefit review of potential household competition.

¹ “A better deal: boosting competition to bring down bills for families and firms”, Treasury, November 2015.

² “Government proposes competition for household customers; a credit negative”, Moody’s, December 2015.

2. Proposed scope of work

This report will explore changes in counterparty risk that could arise as a result of the introduction of retail household competition. We propose that it should, *inter alia*:

- Assess the key counterparty risk factors under the current vertically integrated regime, how Ofwat recognises these and whether Ofwat makes an economic allowance for these.
- Evaluate the approach to counterparty risk taken by Ofwat in relation to non-household competition, including the absence of any allowance made by Ofwat for incremental credit risk exposure and the corollary expectation of wholesalers that they will not be exposed to additional risk.
- Evaluate the changes in counterparty risk factors (including any new risk factors or risk factors that would no longer exist) if the non-household retail competition model were to be applied in respect of household competition, including but not limited to:
 - the impact on wholesalers of retailer insolvency or default under different scenarios (including potential revenue at risk);
 - the cost of capital of an integrated water company compared to a separate retailer and wholesaler given impact of counterparty risk exposure, credit ratings and relative balance sheets; and
 - an assessment of the impact on total credit risk costs assumed across the industry by adding an additional retailer chain into the sector.
- Identify the extent to which risk could be reduced naturally as the market evolves, for example as retailers 'bid away' initial levels of risk through competitive tension.
- Identify possible ways in which incremental counterparty risk could be partly or completely mitigated, including:
 - structural protections for wholesalers and/or retailers via regulatory mechanisms;
 - structural protections for wholesalers and/or retailers via alternative market mechanisms;
 - centralised or industry-wide frameworks that 'pool' retailer credit risk, thereby allowing wholesalers timely recovery of retail credit-related losses;
 - potential supplier of last resort arrangements for customers of a failed retailer or those unable to secure a retailer for some other reason;
 - arrangements for receivables financing in the event of a retailer failing, for example by providing priority access for wholesalers in such circumstances;
 - financial market-based solutions potentially available to wholesalers and/or retailers from the banking, capital and/or insurance markets (including an assessment of costs and criteria to access);
 - an evaluation of retailer credit risk assessment tools; and precedents from other relevant regulatory regimes and sectors.
- Explore the working capital requirements of options to mitigate counterparty risk.

3. Outputs

The output is to be a concise written report that can be published.

The report will be made available by 21 March 2016.

4. Contact and Governance arrangements

This report will be commissioned by Thames Water. The relevant contact will be Colm Gibson, Head of Economic Regulation.