Note of Ofwat credit terms workshop 19 February 2016, facilitated by KPMG

The importance of credit terms

Payment and credit terms have the potential to impact significantly on the effectiveness of the new retail market. The arrangements impact directly on the working capital costs for all retailers and wholesalers and so affect the financial resilience of companies in the market.

They also represent an important issue for customers – if the working capital arrangements are too onerous on retailers then this could inhibit their appetite to enter the market thus impacting on the levels of choice customers have and the quality of the market outcomes. Similarly, if the arrangements allow entrants into the sector without sufficient collateral behind them then there is a greater risk that those retailers may go out of business, putting customers' supplies at risk.

The credit workshop on 19 February

Ofwat has previously undertaken some work on potential credit and payment terms both as part of the 2014 Price review and as part of the development of the draft market codes, including an earlier workshop in June 2015.

The current draft codes include provisions to allow a variety of different forms of credit to be posted between retailers and wholesalers, depending on the financial standing and credit risk of the retailer. However, the precise amounts/values of credit will need to be agreed and formally defined in the codes, as well as the transitional arrangements for retailers to move between the different forms of credit should the financial standing of the retailer change. This work is focussed upon filling those gaps.

On 19 February 2016, Ofwat held an industry workshop that was facilitated by KPMG (Ofwat has appointed KPMG to lead this work on its behalf) to discuss its proposed approach to calculating these values and constructing the transitional arrangements. The workshop was attended by over 30 participants, including new entrants, existing retailers, retailers associated with wholesalers and wholesalers. In addition, representatives from MOSL and Defra were also present.

KPMG led the discussion, and participants then discussed one of the six payment options in table discussions. The key points from both the general discussion and group tables are set out below.

General discussion

Policy issues

Risks and risk management

- There is a need to set out the key principles around credit risk and where this is seen to fall (i.e. on retailers, wholesalers, customers).
- Ofwat should consider introducing a regulatory backstop – eg, per the DCUSA model or some type of ex-post recovery/cost socialisation mechanism on the wholesale side.
- Where a wholesaler ends a contract and thus there is no contracting party but there is still a supply, there was a question around how the wholesaler recovers that revenue.
- If a retailer defaults with one wholesaler, there was a question around wheteher that retailler should be deemed in default with all wholesalers. And there was a linked question around whether default is considered a regional or national event.
- There was a question raised on what happens if a retailer was to default on a term that is not related to payment/collateral. Would this this trigger financial default/interim supply?
- The impact on a wholesaler (in a group context) will be greater if a margin squeeze on the retail side is created – fines of up to 10% global group revenues will be greater than potential risk exposure of wholesaler in relation to retailers.

Practicalities

- Given the number of options available, wholesalers and potential retailers involved, parties may face a complicated set of arrangements, with an associated administrative burden, for example in legal fees.

- A question was raised around whether a retailer would be able to use the same credit option/s for all of the wholesalers it interacts with.

- There was a general point raised around whether wholesalers should set themselves up in advance so that they can deal with all forms of collateral, or wait until thay are approached by a retailer for a specific option.

- Some wholesalers raised concerns that the Interim Code Panel was not the right mechanism for agreeing credit terms. Where these affect appointed companies, they considered that Ofwat should consult on these changes formally.

Model assumptions

i) Coverage and timings

- There was a question raised on why 30 days' cover had been assumed. ~65 was suggested by some members of the workshop (with 75 days currently assumed in Codes, allowing for weekends).

- The assumption about retail market share (50%) was considered to be too high by many members of the workshop. The counter-argument to this from some participants was that the full risk had to be covered regardless of probability because it was considered that no one can predict how the market will develop.

- Ofwat needs to clarify and potentially revise the timings around default and commencement of the Interim Supply process and whether/how Ofwat is involved in this process. The view of many members of the workshop was that it is not realistic to assume that default occurs immediately.

ii) Transition arrangements (general)

- It may be impossible for a retailer to be in compliance with its payments if there is a delay in obtaining additional collateral if required. There was a linked point made that retailers could be deemed to be in default in the transition phase between one credit option and another.

- Apart from credit downgrade and payment history, it was considered by some participants that a change of company ownership would lead to a change in credit option. This would provide additional burden on wholesalers to monitor retailers.

- It was considered that a time period of ten days for a retailer to obtain additional collateral is not realistic.

Feedback from individual table discussions

Option 1 (cash deposit)

Transition arrangements

- Relevant triggers for changing to a different credit option could include credit score and payment history; another could be market share, perhaps considering the balance of local and national customers. Relative exposure of customer numbers/value to wholesaler could also be a trigger.

- Retailers should be required to report relevant changes, but the wholesaler should also be responsible for due diligence and monitoring retailers' performance – there is a potential role for MOSL/Ofwat here, and where there is a dispute in a mediation role.

- There should not be an assumption on any particular form of collateral required if the current option is not sufficient – the retailer should be able to post any form of additional collateral as long as criteria are met.

Option 2 (letter of credit)

General

- In general, a letter of credit was deemed acceptable, but the devil is in the detail.

- It was suggested that the letter of credit should come from an appropriately-rated bank.

- The timescales associated with letters of credit tend to be three years and this time period was considered by some participants to be too long for a minimum tenor. Instead, it was suggested that the period should be one year or less and the coverage needs to be for the “full period of risk” and recovery needs to be 100%.

- To reduce the burden on retailers it was suggested that in an ideal world there would be a standard form of letter of credit. A linked point was made that there would be an increased administration burden to manage if a letter of credit is needed for every wholesaler.

- In a rapidly changing market it was considered that a letter of credit may be too inflexible.

Transition arrangements

- It was considered by participants that ten days to change options/increase collateral is too short.

- The trigger for more collateral needs to be activated before the ceiling of the current letter of credit is reached – it could potentially be too late if parties were to wait until the collateral in place was considered insufficient, as it could take banks two months or more to arrange an increase or issue a new letter of credit.

- It was suggested that the retailer should monitor the adequacy of its collateral and report this on agreed timescales.

Option 3 (Parent Company Guarantee)

General

- The concept of a guarantee is generally acceptable to wholesalers as an idea, but should provide ~90 days of cover for wholesale.

- Retailers were concerned of the impact this could have on their margins.

- A fully codified guarantee would provide no discretion for wholesalers, but equally there would be no room for commercial negotiation between participants.

Transition arrangements

- If a retailer chooses to move to another credit option proactively, there should be no gap in the cover it provides to the wholesaler – there is a risk that if the parent loses its credit rating, it will take more than ten days for the retailer to obtain new collateral.

Option 4 (unsecured credit)

General

- It was considered by members of the workshop that it was unclear whether there is a workable solution for how unsecured credit could be an option without leaving the wholesaler exposed to too much risk. It was suggested that one possible way might be for it to be the wholesaler's choice whether to accept unsecured credit.

- The assumption that the highest credit rating should allow 100% unsecured credit is not reasonable and was considered too risky for wholesalers.

- It was suggested that credit ratings could instead be used to reduce the amount of cover.

- There were concerns raised about how often and easy it would be for wholesalers to monitor the credit situation of retailers, and there were concerns about the speed, access to and quality of the relevant information available.

Option 5 (insurance)

General

- There was a general disagreement on the coverage period suggested - retailers tended to favour 30 days, with wholesalers tending to favour ~90 days.

- It was noted that recovery and cost tend to follow the inherent risk of the retail entities in the market, which seemed a fair approach.

- It was considered that the working capital costs assumed in the model seemed low.

- It was considered that the insurance option should provide alternative options for participants that are not able to assure a particular credit score. However, it was noted that this option is considered to be complex for new entrants. The attractiveness of this option depends on the company's scale and the range of costs makes this option less attractive for smaller participants.

- It is assumed that insurance would be the last resort, after a retailer had tried other options – PCG, letter of credit, etc; a concern was raised that this might indicate that the retailer is not creditworthy, when potentially this is not the case.

Option 6 (pre-payment)

General

- It was considered unclear why the billing period was chosen also as the coverage period.

- There was general support for the 4-8% assumption for retail working capital costs but recognition that this was more of a binary position than a range – if retailers are able to raise debt they will with lower working capital at the bottom of this range and if they are not then they will have working capital costs towards the top of this range.

- There was some uncertainty around when triggers will get activated, including potentially by Ofwat and a desire for greater certainty about the timeframes and circumstances under which Ofwat might activate those triggers.

- A question was raised to whether reallocating all of this risk into the wholesale price control and ultimately passing it to end-customers would be a more efficient allocation of risk – this could be done for some or all of the default risk with the precedent of the DCUSA model emphasised.

Next steps

Ofwat invited further views and comments to be submitted by close, Wednesday 24 February. Ofwat would then work with KPMG to develop draft proposals to be discussed by the Interim Code Panel at its March meeting, before submitting code change proposals to the panel at its April meeting.

However, some wholesalers raised concerns that the Interim Code Panel was not the right mechanism for agreeing credit terms. Where these affect appointed companies they considered that Ofwat should consult on these changes formally. Ofwat agreed to take away this issue and consider the next steps, including whether a formal consultation may result in code changes being taken to a future Interim Code Panel meeting.