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Trust in water

Credit terms between wholesalers and retailers in the new retail market

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About this document

This document sets out our decisions in respect of the credit and collateral arrangements between wholesalers and retailers in the new business retail market. It also summarises the responses we received to our consultation 'Credit terms between wholesalers and retailers in the new retail market – a consultation' and responds to the issues and evidence raised in response to that consultation, which we have taken into account in reaching our final policy.

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Executive summary

Background and purpose

The Water Act 2014 (WA14) will allow eligible business, charity and public sector customers (referred to as business customers in the rest of this document) to choose their supplier of water and wastewater retail services from April 2017. For customers of water and wastewater companies wholly or mainly in England, the market will be extended to include all business customers. The Welsh Government has adopted a different policy position to the UK Government and has not sought to extend competition into these services. However, customers of water and wastewater companies wholly or mainly in Wales using more than 50 Ml of water each year will continue to be able to choose their water supplier as they can now.

Credit arrangements are an important aspect of any market arrangement. Any disproportionate, discriminatory or unclear credit arrangements could act as a barrier to entry for new entrants, resulting in a chilling effect on the levels of rivalry and choice in the new market, to the detriment of customers. Similarly, if credit arrangements do not adequately address the risks that wholesalers are exposed to under the new arrangements then they could potentially, in extreme circumstances, impact on the financeability of the wholesaler. Finally, most significantly, if the risks of default are not allocated efficiently then the new arrangements may tie up capital in the new arrangements, unnecessarily creating costs and inefficiency or encouraging excessively risky entry and bad debts which may be passed on to customers.

This document sets out our decisions in respect of the credit and collateral arrangements between wholesalers and retailers in the new business retail market. It also summarises the responses we received to our consultation 'Credit terms between wholesalers and retailers in the new retail market – a consultation' and responds to the issues and evidence raised in response to that consultation which we have taken into account in reaching our final policy.

Responses to the consultation

We received 23 responses to our consultation including 15 wholesalers, 7 retailers and the Consumer Council for Water. A full list of respondents is included in Appendix 1, with our evaluation of those responses and the points raised set out in section 2.

Our decisions

For the purposes of setting out clearly our key decisions, we have grouped them into four key themes (analysis, level of collateral, suite of credit options and wholesale risk sharing mechanism) that reflect the issues we sought stakeholders' views on in our consultation. Our decisions are explained in more detail in section 2.

Analysis – we set out our analysis and the underlying assumptions used in detail in Appendix 1 to our consultation that examined both a) the likely working capital and collateral costs to retailers from the arrangements' impact on retail margins, and b) the impact on wholesalers of working capital costs and revenues from a major retailer default.

On the basis of the responses and evidence provided we have decided to retain the approach and assumptions used as part of our original analysis. We have however updated the impacts on retailers to show more clearly the impact of requiring 50 days of collateral.

Level of collateral – based on our analysis and a review of precedents in other sectors, we proposed that retailers should be required to provide 50 days of collateral (or around 60% of the risk) to wholesalers.

We recognise that there are many wholesalers and retailers that have raised concerns with the suggested 50 days of collateral that should be required from retail entrants. We consider that this largely reflects the challenge of efficiently allocating risk so as to promote competition and reduce barriers to entry in retail services and avoid imposing undue or inefficient costs on wholesalers. However, overall in relation to the level of collateral required, we consider that the position we reached in the consultation represents a fair and efficient allocation of risk between wholesalers and retailers, reflecting our analysis and the precedents from other sectors that we have considered and best meets our objectives.

Key decision 1 – Within the regulated credit arrangements for the retail market set out in the wholesale-retail code we expect retailers to provide 50 days of collateral to wholesalers to cover the risk of retailer default for all post-payment options.

We do not consider that, on its own, the evidence emerging from this consultation on credit and working capital arrangements suggests a need to increase the WACC or wholesale cost allowances to compensate for this risk (where 50 days of collateral are provided).

Key decision 2 – We will consider whether there is a more efficient way to manage this risk beyond 2020 through other regulatory tools, after considering the development in the business retail market.

The suite of credit options – given the market power of wholesalers, and the likelihood of different retail business models, we proposed that regulated credit arrangements should be set out in the codes and that a suite of six standard regulated options should be available. We also proposed that a seventh option be added that allowed parties to deviate from the six regulated arrangements where they agreed to do so.

Given the broad support for and the greater flexibility from providing a range of credit options we continue to consider that the codes should specify a menu of different credit options including the unsecured credit option. To provide even greater flexibility we consider that there is merit in including a seventh 'negotiated' credit option, albeit that where this is used wholesalers should face a requirement to publish the terms of that agreement to increase transparency and help to ensure a level playing field.

Key decision 3 – Within the regulated credit arrangements for the retail market set out in the wholesale-retail code we expect a range of options to be provided that are available to retail entrants. This should include pre-payment (acknowledging that this is not strictly a 'credit' option in reality), cash deposit, letter of credit, third party guarantee, insurance and unsecured credit based on the requirements set out in appendix 2 that have been updated following meetings of an industry working group. Retailers should be free to choose from any of these options and wholesalers must accept them, provided that retailers meet the criteria set out in the codes.

Key decision 4 – Within the regulated credit arrangements for the retail market set out in the wholesale-retail code we expect there to be a negotiated credit option. This should allow retailers and wholesalers to agree alternative, bespoke negotiated credit terms where both parties agree to these. Where this option is adopted, wholesalers must publish the terms of such agreements.

Retailers may serve business customers in a single region or in multiple regions. A default could therefore affect only one wholesaler, or multiple wholesalers. A retailer serving multiple regions may be in default with one wholesaler, but not in default with others. The other wholesalers may be unaware that the retailer is in default and therefore unaware of the default risk they face.

For this reason, and for the orderly operation of the market, we proposed in the consultation to treat a retailer in default with one wholesaler as being in default with all wholesalers, and the credit support options in place would apply to all wholesalers affected. We did not receive any challenge to this proposal, and as such we confirm that retailers in default with one wholesaler will be in default with all wholesalers who they have entered into a contract with.

Key decision 5 – Within the regulated credit arrangements for the retail market set out in the market arrangements code and wholesale-retail code we expect that a retailer in default with one wholesaler should be treated as being in default with all wholesalers.

Within the discussion on credit options in the consultation, we asked for stakeholders' views on how the level of unsecured credit available to retailers should be assessed. Our proposals included a scale based on the creditworthiness of the retailer in question. We discuss this separately in section 2.4.2 below.

We agree with the points raised in the consultation that the unsecured credit scale may not be appropriate and in particular that:

- The scale should take greater account of the difference between investment grade credit ratings and other ratings - there should be a greater step up at this point in relation to the amount of unsecured credit that is available; and
- There should also be an ability to provide a credit score as a means of securing unsecured credit as an alternative to investment grade rating (for example, for retailers who are unable to access an investment grade rating) and that there needs to be a clearer correlation between credit ratings, scores and access to unsecured credit.

Based on the concerns raised we have revisited the scale, which was drawn from the DCUSA arrangements with some adjustments. DCUSA was selected as being one of the few relevant precedents setting out a mechanism for quantifying unsecured credit allowances against creditworthiness. However, the regime surrounding the DCUSA arrangements are not identical to those in water. Based on a review of evidence on the relative riskiness of different investment grade credit ratings and credit scores and the implications for incentives and level playing field we have decided that:

- All companies with an investment grade credit rating should be able to gain access to 40% unsecured credit. This is consistent with the approach used elsewhere in the regulatory settlement (where we make no distinction between different ratings) and the relative riskiness of investment and other grade credit ratings

- Allow companies with excellent credit scores (a score of 9/10) to obtain 20% unsecured credit, to reflect the creditworthiness of these retailers, provide an incentive for timely payment and to ensure a level playing field (as all retailers might not be able to secure a credit rating).

- Allow retailers with good credit scores (A score of 7/8) to obtain 10% unsecured credit as obtaining the highest credit score might be difficult for retailers, at least initially and the difference in risks are relatively small.

Key decision 6 – Within the regulated credit arrangements for the retail market set out in the wholesale-retail code we expect there to be a scale for unsecured credit that is set out in section 2.4.2 and appendix 2.

Finally, we agree with many of the points raised about the level of detail set out in the credit arrangements. Further detail on how these arrangements will operate in practice will support the efficient operation and administration of the market and minimise barriers to entry. In parallel with this decision document we have established a small working group of wholesalers and retailers to consider a range of more detailed points around how the various credit arrangements work in practice, including those raised by respondents. The group will not revisit any of the decisions set out in this document. Once this group have worked through some of these more detailed points, we will prepare a change proposal for the codes which we intend to take to the ICP meeting in September for inclusion in the codes.

A wholesale risk sharing mechanism – we considered the case for a wholesale risk sharing mechanism that would allow wholesale price limits to be re-opened in the event of a major retailer default under certain circumstances, effectively transferring some of the risk onto customers.

Based on the evidence provided we will not introduce a risk sharing mechanism at this time. Our analysis suggests that, even in a worst case scenario, the impact on wholesalers would not be of such significance as to threaten their financeability and evidence and responses from stakeholders appears to confirm this given the levels of collateral provided by retailers, especially for the period up to PR19. We also recognise that such a mechanism would be complex to implement and believe that it is unnecessary at this time in light of the existing risk sharing mechanisms that are available – wholesalers can already seek recourse to the regulator to re-open or true-up price limits in certain circumstances, for example through Interim Determinations. These mechanisms, whilst not specifically designed for this purpose, should be sufficient to address any issues including retailer default that may threaten the financeability of an efficient wholesale business. We will keep the desirability of risk sharing under review after market opening.

Key decision 7 – We will not introduce a wholesale risk sharing mechanism, but will review credit arrangements after the market is open.

Next steps

We recognise that the credit terms are an important gap in the current market arrangements and many respondents to the consultation wanted us to resolve the outstanding issues with the arrangements swiftly.

Implementing these credit arrangements will principally require the updating of the 'codes', including the Wholesale and Retail Code and the Market Arrangements Code that are available in draft form on the Open Water website and are governed by the Interim Code Panel which makes recommendations to Ofwat that we must then accept or reject. We plan to develop a change proposal for the codes and discuss that proposal with the Interim Code Panel in September and, if necessary, October based on this policy statement. Where we have set out decisions in this document we are unlikely to approve recommendations for change from the ICP that run counter to those decisions.

Before that, and following discussion with the Interim Code Panel, we have established a working group with balanced representation to develop further detail on how the credit arrangements will operate in practise, including considering some of the more detailed issues and practical concerns raised by respondents to the consultation. This working group will not consider the thresholds associated with unsecured credit or any of the decisions set out in this document.

1. Introduction

At present, only a limited number of business, charity and public sector customers across England and Wales can choose their retailer – but this will change significantly in April next year.

The Water Act 2014 (WA14) will allow eligible business, charity and public sector customers (referred to as business customers in the rest of this document) to choose their supplier of water and wastewater retail services from April 2017. For customers of water and wastewater companies wholly or mainly in England, the market will be extended to include all business customers. The Welsh Government has adopted a different policy position to the UK Government and has not sought to extend competition into these services. Regulation will therefore remain the core tool for protecting customers and driving improvements in service and value for money for these customers in Wales. However, customers of water and wastewater companies wholly or mainly in Wales using more than 50 Ml of water each year will continue to be able to choose their water supplier as they can now.

Credit terms are an important aspect of any market arrangement. Any disproportionate, discriminatory or unclear credit arrangements could act as a barrier to entry for new entrants, resulting in a chilling effect on the levels of rivalry and choice in the new market, to the detriment of customers. Similarly, if credit arrangements do not adequately address the risks that wholesalers are exposed to under the new arrangements then they could potentially, in extreme circumstances, impact on the financeability of the wholesaler and the delivery of the essential water and wastewater services that customers rely on. Finally, most significantly, if the risks of default are not allocated efficiently then the new arrangements may tie up capital in the new arrangements, unnecessarily creating costs and inefficiency or encouraging excessively risky entry and bad debts which may be passed on to customers.

This document sets out our final decisions in relation to the proposed credit arrangements for the new retail market and appointed wholesale companies that are subject to price regulation. It also explains how we propose to implement those arrangements.

2. Credit arrangements for the new retail market

Within this section we set out the proposals in our consultation document and discuss the key issues and challenges raised by stakeholders (along with any evidence provided), including, where appropriate, an explanation of how we have taken those into account in reaching our decisions. These are set out against the four key areas previously described.

2.1 Summary of our consultation proposals

In our consultation we set out our proposed credit arrangements for the new business retail market. The consultation sought views and evidence in response to our draft policy and asked a number of questions that can be grouped into four broad areas:

1. **Analysis –** as part of our consultation we presented some analysis that examined both a) the likely working capital and collateral costs to retailers from the arrangements' and the corresponding impacts on retail margins, and b) the impact on wholesalers of working capital costs and revenue impacts that may arise from a major retailer default. This analysis was important in underpinning our policy proposals and we therefore invited stakeholders' views on our approach and the underlying assumptions.

2. **Level of collateral –** based on this analysis and a review of precedents in other sectors, we proposed that retailers should be required to provide 50 days of collateral (or around 60% of the risk). We invited views on the proposed level of collateral that should be provided and whether this represented an efficient allocation of risk.

3. **The suite of credit options –** given the substantial market power of wholesalers, we proposed that six regulated credit arrangements (or 'regulated access') should be prescribed in the codes. The large number of different credit options was designed to support a range of different retail business models and provide flexibility to new entrants. We invited views on the six credit options, including both whether they should all be included and how they should operate.

   We also proposed that a seventh option should be added to the six that are already provided for in the codes to allow parties to deviate from the regulated arrangements where they agreed to do so. To avoid risks of discrimination, we suggested that wholesalers would be required to publish the terms of such arrangements.

4. **A wholesale risk sharing mechanism –** we considered the case for a wholesale risk sharing mechanism that would allow wholesale price limits to be re-opened in the event of a major retailer default under certain circumstances, effectively transferring some of the risk onto customers. We set out how such a mechanism could work but, based on the evidence, we did not consider such a mechanism was required at this time.

Finally, we invited views on our proposed next steps and timescales.

We received 23 responses to our consultation including 15 wholesalers, 7 retailers and the Consumer Council for Water. Some respondents decided to focus their response on a particular issue as opposed to responding to the individual questions set out in the consultation. A full list of respondents is included in Appendix 1.

2.2 Analysis and assumptions

Our proposals

To identify the appropriate balance of risk, we made a number of assumptions that underpinned our analysis so that we could assess the impact of the proposed credit arrangements, including an assessment of

- **working capital;**
- **collateral;** and
- **the impact on the wholesaler of a major retailer default**.

Our approach to the analysis was set out in detail in Appendix 1 that supplemented our consultation. Some of the key elements of our analysis were, to an extent, pre-determined, building on the existing settlement arrangements from the design of the central system and the proposals in the codes. For example, we developed the payment timescales based on the timescales for billing and payment that are already established in the draft Wholesale Retail Code and the draft Market Arrangements Code. We also considered the timescales and arrangements established in the Interim Supply Code to understand the full potential exposure to the wholesaler under different options and the corresponding costs on the retailer. The analysis also included assumptions about when retailers are likely to be paid by end customers as this is a key factor that will affect cash-flows and the corresponding need for working capital or collateral cover.

Key issues raised

The majority of responses – 11 out of 15 wholesalers, three out of seven retailers (four were silent on this issue) and CCWater – broadly supported the approach to the analysis and the underlying assumptions and did not suggest any need to update or improve that analysis with many explicitly suggesting that the analysis was sensible and reasonable.

However, a small number of respondents did raise concerns:

- Two wholesalers considered that the assumption of a 1 in 20 year major default event was too risky, given the higher likelihood of default in the early stages of the market. One of these wholesalers added that it is not appropriate to use an assumption based on UK energy, where there are significant differences in the market characteristics;
- One retailer raised concerns that our assumptions were too high around the impact of retailer default, stating that the consultation noted that the observed level of default in the energy market over an 8 year period has equated to 0.02% of total wholesale revenue over the period, while in the Scottish water market the equivalent figure has been approximately 0.002% over a similar timeframe. The retailer further noted that this could result in the cost of this insurance being at least 25 times as large as the expected losses;
- Based on their own work in relation to optimising capital structures, one retailer expected the retail cost of borrowing to be closer to 8% (which we used as a sensitivity for analysis) rather than the 4% we used as our central assumption, this was based on their judgements about the extent to which retailers could raise debt finance;
- One retailer suggested that the analysis of retail working capital was insufficient or may understate retail working capital because it assumes that customers are generally billed monthly whereas many are billed quarterly, increasing the working capital costs on retailers.
- One wholesaler noted that the analysis was predicated on the basis of 82 days of risk exposure for wholesale revenues. They considered that this 82 day assumption was too optimistic as where a retailer is in default, they considered that negotiations may be protracted and as such 82 days is likely to be an underestimate and should be increased; and
- One retailer suggested that the calculations for the cost of credit and cost of working capital were not consistent with the assumptions set out in Appendix 2 of the consultation document and do not fully reflect the upper bound for the cost of some of the credit options.

Evaluation

We have decided to retain the 1 in 20 year assumption. Despite two wholesalers raising this as a concern, most respondents have not raised concerns in relation to this and neither wholesaler made any suggestions for a more reasonable assumption based on evidence. The 1 in 20 probability of default is based on the average impacts of defaults in Scotland (0.08%) and UK energy (0.02%) and the UK insolvency rate of ~0.5%. We acknowledge that our assumptions may be conservative, but we think this represents a realistic upper-end assumption on the risk of default and remain of the view that the impact will be minimal. We also note that the 1 in 20 year assumption is only used for the risk adjusted impacts on wholesalers, whilst our analysis and judgement has given greater weight to the potential actual impacts of a major default in a single year.

We acknowledge that there is an impact on retailers from the timescales in which they receive payments from end customers. Our approach is based on an average period of c.45days across the industry to recover payment from customers that we applied at PR14. This is an average, and whilst payment from some customers may be well behind this figure, some customers will already pay in advance for services. In a market context, we think that earlier payment may be something that retailers encourage customers to do in order to reduce their working capital costs still further. We therefore consider that the approach remains valid.

We do not see a need to change our assumption of an 82 day period of risk exposure. There are a range of possible outcomes included within the analysis, from 73–102 days, based on the various provisions in the codes and the nature of the wholesale/retail interaction (for example under different forms of settlement-pre and post payment). We chose 82 days because it seems on the basis of evidence and precedent to be the most likely. Most respondents were comfortable with this assumption. The arrangements proposed are highly regulated via the market codes and following a period of default the wholesaler is able to terminate (directly) the wholesale contract, pushing the retailer into interim supply and crystallising the liability. It would only go significantly beyond a period of 82 days if a wholesaler chose to do so.

We note the point made around the cost of debt for retailers. However, we already use 8% as an upper-bound sensitivity in our analysis. Most respondents did not raise concerns about this and new entrants are likely to have a range of different business models and capital structures in place which in some cases anecdotal evidence suggest to us could well support lower costs of borrowing than the 8% sensitivity.

We also note the point raised by one retailer around our assumptions on the impact of retailer default. Our assumptions and calculations were intended to represent a range of potential scenarios – for example, our analysis set out a) the potential impact where 100% of a wholesaler's revenues from non-households were at risk of retailer default (for example if a wholesaler's entire revenue base was exposed to a single retailer and that the collateral had failed completely), and b) the potential impact adjusting for the risk of default (assumed as 1 in 20 event) and the level of wholesaler revenue exposed to a retailer default (100% or 50%, taking into account that a wholesaler might provide services to a number of different retailers). Our analysis was also presented in a way that the 4% cost scenario was run in conjunction with the 82 days analysis, and the 8% cost scenario was run with the one calendar month analysis. Our calculations therefore may have understated the upper end of the range. We include a revised estimate of the impact on retailers in a table in section 2.3 below.

One of the main difference between our and the retailers calculations is around the assumptions used for working capital costs. The retailer assumed that working capital was required for 30 days compared to the 15 days in our analysis. We continue to consider that our assumption of 15 days of working capital is reasonable. The working capital requirement is driven by the difference between when the retailer has to pay the wholesaler and when it gets paid by the end customer. The retailer will pay the wholesaler 30 days after the end of the period in question. Based on the average debtor days estimated as part of PR14, the end customer will pay the retailer after 45 days after an invoice is issued. Consequently the retailer will have 15 days of exposure which needs to be covered by working capital. We acknowledge that debtor days will vary across companies and will depend, in part, on whether companies bill, monthly quarterly or in advance. This will be an important area for retailers to manage as part of their operations in the new retail market. We continue to consider that the working capital assumptions are reasonable for a notional retailer.

A retailer also suggested that Figure 4 of the consultation document (which highlighted the potential impact on retailer margins) did not present the upper ranges of the possible costs to retailers. The information in the consultation represented a reasonable set of average likely costs. Feedback at the stakeholder workshop in February, where our assumptions were discussed and challenged, indicated that most stakeholders considered that the costs presented were reasonable and possibly over-stated. Subsequent discussions with banks and companies have confirmed that our lower end ranges may still be too high and that even lower costs might apply for some companies, and so we see no reason to alter our assumptions.

Decisions

On the basis of the responses and evidence provided we have decided to retain the approach and assumptions used as part of our original analysis. We have however updated the impacts on retailers to show more clearly the impact of requiring 50 days of collateral.

2.3 Level of collateral

Our proposals

The analysis set out in the consultation was an important part of the evidence that led us to a proposal of requiring retailers to provide 50 days of collateral (equivalent to allocating c60% of the risk) to wholesalers. However, we also reviewed the precedent arrangements in other sectors, including the UK electricity and gas distribution arrangements under the Distribution Connection and Use of System Agreement (DCUSA) provisions, where wholesalers are subject to 40% of these risks in the event of a retailer default. We think that, based on our analysis, this represents a fair and efficient balance of risk.

As part of our consideration of where to allocate this risk, we also explicitly considered our dual objectives of promoting effective competition in the retail market (for example, by minimising barriers to entry and expansion in that market) and maintaining the financial stability of the wholesaler and the fulfilment of their essential functions.

Key issues raised

Seven respondents – four out of 14 wholesalers and two out of seven retailers (with four being silent on this issue) and CCWater – supported the suggestion that retailers should provide 50 days of collateral to wholesalers to cover the risk of retailer default. One retailer thought that this was too burdensome, and could result in a highly disproportionate level of cost for the industry in comparison to the expected level of loss. Seven respondents (including both wholesalers and retailers) did not agree with the proposal.

Some of the key points made in response to our proposal were:

- Seven wholesalers made the point that they should not be required to cover any of the risk of retailer default as this was not allowed for or factored into the PR14 settlement. They suggested that if wholesalers are required to cover

this, then it should be reflected in the WACC or wholesale cost assessment at PR19;
- One wholesaler suggested that the PR14 retail margin and cost assessment did not account for working capital and collateral arrangements adequately, and if the 50 days is to be retained then either the retail margins or cost allowances should be increased in PR16 to cover these costs;
- A wholesaler stated that the current suite of payment options does not represent a fair and efficient allocation of risk. For example, currently, the prepayment option (based on our assumed payment timescales) leaves the wholesaler with 12 days of exposure to risk, whereas any collateral arrangement exposes the wholesaler, on average, to 32 days of risk. The wholesaler does not believe this difference is justified and suggests that Ofwat should equalise the risk to wholesalers across all of the options;
- A wholesaler raised the point that a stipulation that 50 days collateral cover is offered to all retailers, regardless of the risk, results in a 'one size fits all' approach to the wholesaler risk framework. This could lead to scenarios where wholesalers are taking on risks for counterparties who, in other sectors, would have to provide full coverage due to their risk profile;
- Two retailers and CCWater raised concerns that the proposed level of collateral could see some groups of customer effectively excluded from the competitive market due to the erosion of available retail margins;
- Finally, two retailers raised concerns that requiring all retailers to provide actual collateral against 50 days of wholesale charges would result in a disproportionate level of cost for the industry in comparison to the expected level of loss. The retailers suggested that retailers able to demonstrate excellent credit histories should have this reflected in the level of collateral required from them.

Evaluation

As part of our work during PR14, we conducted an assessment on the balance of risk and reward at both the wholesale and appointed company level, considering the latest market evidence, including equity beta evidence from the energy sector and company submissions (who will have been aware about these risks in making those submissions) in reaching decisions around the wholesale cost of capital and retail margins. We estimated an appointee cost of capital, which was decomposed into two components: the wholesale cost of capital and retail margins. The wholesale cost of capital was based on the appointee cost of capital with a deduction of the 1% retail margin for both residential and business customers i.e. no deduction for the additional margin on business customers. At the time of setting the wholesale cost of capital we were explicit that the "there are considerable differences between water retailing in Scotland and England – in particular, working capital requirements for water companies in England are likely to be lower"[1].

We note that all companies, apart from Bristol Water, accepted the cost of capital as part of their final determinations, and the cost of capital estimated by the CMA in the Bristol Water appeal was similar to that allowed for in the final determinations[2]. We also note that no companies asked for the risk of retailer default to be included as a special cost factor claim or an uncertainty mechanism as part of the PR14 final determinations.

In relation to retail margins, the analysis that was undertaken by PwC in support of retail margins at PR14 examined margins in a range of comparative sectors. Whilst some of those sectors have different characteristics, all of them have credit and collateral arrangements and many of those arrangements place larger requirements on retailers in those markets by asking them to cover 100% (rather than c.60%) of the risk of retailer default.

The table below sets out the updated impacts on retailers arising from the cost of credit and working capital, considering both total exposure of 82 days adjusted downwards to reflect our decision to require 50 days collateral. It is useful to consider these net margin requirements with the overage net margin of 2.5% allowed in PR14, the lowest net margins by tariff band proposed by companies in the business retail default tariffs (0.7%) and the 0.4% working capital net margin requirement referred to in the draft method statement for PR16 based on PwC analysis. All of the proposed credit impacts are below the 2.5% net margin allowance. While the cost of some of the credit options exceed the lowest net margins proposed by companies, the allocation of the 2.5% net margin across tariff bands is an issue for companies and could reflect the lower credit risk of different types/sizes of companies. We also note that while the cost of all of the credit options apart from unsecured credit exceeds the 0.4% allowance set out in the PR16 method statement, companies have a choice of credit options and it is quite possible that companies using a combination of credit options would be able to outperform the 0.4% allowance. Consequently we consider that the 50 days credit requirement is consistent with a net margin of 2.5%.

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[1] Ofwat, January 2014, "PR14 risk and reward guidance"
[2] CMA, Bristol Water plc: A reference under section 12(3)(a) of the Water Industry Act 1991, Final report, October 2015.

Option		Impacts on retailer		
	Cost of collateral option	R2 Cost of credit (Margin impact expressed as reduction against 2.5% retail net margin)	R1 Working capital (margin impact expressed as reduction against 2.5% retail net margin)	R1+R2 Total impact
Cash	4%-8%	51 bps – 102 bps	13 bps – 26 bps	64 bps – 128 bps
Letter of credit	4%-8%	51 bps – 102 bps		64 bps – 128 bps
Guarantee	3%-6%	38 bps – 77 bps		51 bps – 103 bps
Insurance	5%-10%	64 bps – 128 bps		77 bps – 154 bps
Unsecured credit	n/a	0 bps		13 bps – 26 bps
Pre-payment	n/a	0 bps	81 bps – 162 bps	81 bps – 162 bps

Finally, whilst we agree that, at least on a risk-adjusted basis the risk to wholesalers from a retailer default is substantially lower than the level of collateral provided, the impact of an actual, significant default would be much greater than the collateral provided. Given that in other sectors such defaults have been rare and recognising the difficulty of assuming how regularly such defaults would occur, as evidenced by the concerns raised by stakeholders in response to the 1 in 20 year assumption, we have also taken account of the impact of an actual default in reaching our conclusions in determining the balance of risk.

Decisions

We recognise that there are many wholesalers and retailers that have, for varying reasons, raised concerns with the suggested 50 days of collateral that should be required from retail entrants. We consider that this largely reflects the challenge efficiently allocating risk so as to promote competition and reduce barriers to entry in retail services and avoiding imposing undue or inefficient costs on wholesalers. However, overall in relation to the level of collateral required, we consider that the position we reached in the consultation represents a fair and efficient allocation of risk between wholesalers and retailers, reflecting our analysis and the precedents from other sectors that we have considered and best meets our objectives.

Key decision 1 – Within the regulated credit arrangements for the retail market set out in the wholesale-retail code that we expect retailers to provide 50 days of collateral to wholesalers to cover the risk of retailer default for all post-payment options.

We do not consider that, on its own, the evidence emerging from this consultation on credit and working capital arrangements suggests a need to increase the WACC or wholesale cost allowances to compensate for the risk of retailer default (where 50 days of collateral are provided).

Key decision 2 – We will review whether there is a more efficient way to manage this risk beyond 2020 through other regulatory tools, after considering the development in the business retail market.

2.4 Credit options

2.4.1 Range of credit options

Our proposals

Both the Cave review in 2009 and the UK Government's White Paper considered that a 'regulated' form of access to the retail market was most appropriate and favourable to a 'negotiated' approach to provide certainty to new entrants and in recognition of the market power of wholesalers and the incentives and opportunities that they may have to disrupt entry. Recognising this concern, the new retail market will be supported by a set of 'codes', including the wholesale-retail code and the market arrangements code. These codes will define the processes and procedures for all interactions between wholesalers and retailers in the new retail market and support a level playing field for the new market. They will therefore need to define and include the various credit arrangements.

Recognising that retailers may choose to adopt a number of different business models and have different levels of credit risk, we proposed that a menu of credit options be developed and set out in the codes. To summarise, the suite of credit options we suggested be included in the codes comprises:

- **Cash:** This involves the retailer placing a defined amount into a secure bank account established by the wholesaler.

- **Letter of credit:** A financial instrument in which an issuing bank agrees to make a payment to the wholesaler if certain contractual conditions are not met by the retailer.

- **Third party guarantee:** Involves a guarantee of payment or performance of financial obligations of the retailer by a parent company or third party guarantor.

- **Insurance:** Involves a surety bond issued by an insurance company on behalf of a retailer, guaranteeing the performance of the retailer's financial obligations. Surety bonds are not one-size-fits-all financial instruments and can be tailored to the specific circumstances of the retailer and wholesaler.

- **Unsecured credit:** Consists of an unsecured allowance as a proportion of otherwise collateralised charges and liabilities, the amount of which is usually calculated based on an assessment of the financial standing of a retailer (i.e. their creditworthiness) or their payment history. Retailers are allocated a specific percentage allowance of unsecured credit based on their creditworthiness as measured by their credit rating. In cases where retailers do not have an approved credit rating, participants can be provided with an unsecured credit allowance through either an independent credit score or through the demonstration of good payment history with the wholesaler.

- **Pre-payment:** Not strictly a 'credit' option and so should be considered in isolation**.** A pre-payment involves payment in advance by the retailer of the estimated cost associated with delivering a service by the wholesaler, equal to one calendar month.

We also proposed in the consultation that a seventh **negotiated** option be added that allows parties to deviate from the six regulated arrangements where both retailers and wholesalers agree to do so (i.e. where alternatives are agreed). To avoid risks of discrimination, we suggested that wholesalers should be required to publish the terms of such arrangements in full to make them transparent to all retailers.

Specific details of the individual features associated with each of the credit options are set out in appendix 2. We separately sought views on how the level of unsecured credit available to retailers is established, and discuss this in section 2.4.2.

Key issues raised

14 respondents - seven out of 14 wholesalers, six out of seven retailers (with one silent on this issue) and CCWater - supported the inclusion of the six credit options and the introduction of a seventh 'by agreement' option. Some of the key issues raised in response to our proposal were:

- Four wholesalers suggested that unsecured credit should be removed as an option, and if it is not then only an investment grade credit rating that is the same as or better than the relevant wholesaler should allow an entrant to gain unsecured credit. They were concerned about the potential impact on their own credit ratings of a counterparty with a lower credit rating;

- One wholesaler supported the approach and agreed that the mix of credit options will establish a level playing field for new entrants as well as protecting the wholesaler from unnecessary risk;
- Two retailers wished to see the unsecured credit option expanded and the arrangements loosened to allow greater volumes of unsecured credit for new entrants to support entry into the market and promote competition for the benefit of customers;
- Two wholesalers raised concerns around the burden for managing credit and collateral arrangements, in particular highlighting the difficulty in managing this in a market where retailers are growing rapidly;
- One wholesaler suggested that an investment grade rating should be required to underpin the letter of credit, insurance and third party guarantees, with another wholesaler suggesting that a minimum of A- rating would be needed for a third party guarantee and letter of credit;
- One wholesaler suggested that guarantees issued by an associated company (i.e. a parent) would need to be written under UK law as opposed to our proposal of being enforceable under UK law, which we thought would allow flexibility for retailers in who they chose to provide such guarantees;
- One retailer encouraged Ofwat to explore measures around restricting the ability of wholesalers to unreasonably refuse proposed terms; and
- Several respondents, both wholesalers and retailers, raised concerns about the level of detail in our proposals around how the credit and collateral arrangements would work in practice, including, for example:
    - a suggestion that standard templates could be provided for Letters of Credit, Parent Company Guarantee's, etc.;
    - the need to clearly define investment grade credit in the codes, with a suggestion that the definition used should be similar to that in the existing Instrument of Appointments;
    - the need to set out more clearly how each of the options interact and how retailers may move between different options;

Water Industry Commission for Scotland (WICS)

When developing our proposals we have also considered the arrangements in Scotland. There are two credit terms currently offered by Scottish Water to licenced retailers in Scotland - (i) standard pre-payment, and (ii) pre-payment with an additional requirement to maintain funds in an escrow account controlled by Scottish Water. The standard pre-payment terms are that the retailer pays Scottish Water the estimated wholesale charges for each month ten business days before the start of that month. On receipt of payment from the retailer, Scottish Water has a pre-payment of up to 32 business days.

In July 2016, WICS published a short consultation proposing to amend the existing credit arrangements for the Scottish market. WICS proposes, subject to consultation responses, to make the following changes to all current and future credit terms:

- to increase the pre-payment required from retailers to Scottish Water to a maximum of 54 business days from the current 32 business days;
- no further escrow accounts are entered into and existing escrow accounts are closed (at the same time as the above change takes affect) and the proceeds returned to the appropriate retailer; and
- Scottish Water pays interest on pre-payments at an annual rate of 4% nominal, which is the cost of debt allowed for in Scottish Water's price review.

Evaluation

We welcome the broad agreement across stakeholders that the suite of credit options proposed in the consultation should be taken forward and written into the wholesale-retail code. In response to some of the points raised:

- We recognise that the costs imposed on retailers will be different under the pre and post payment options (indeed, this was reflected in our analysis published in our consultation). We do not consider that there is a need to ensure parity between these different options on level playing field grounds. Entrants will have a range of different credit options within the codes that they can access with certainty. The inclusion of a pre-payment option, which we understand is the most common method of payment in Scotland, will continue to ensure the interoperability of the two markets - which is an important objective for the Open Water programme.
- We recognise that regulated requirements may drive a more rigid approach. We do not believe that this will be 'one size fits all' as there will be up to seven different options available to retailers, including pre and post payment options, but recognise that a 'negotiated' arrangement would provide more flexibility. We consider that the arrangements protect against the risk of retailer default by taking into account the overall credit risk of the retailer and seeking to provide proportionate levels of collateral to cover that risk. We also remain of the view that, given the clear market power of wholesalers a set of regulated requirements are necessary and appropriate.
- We do not agree that unsecured credit should be removed as an option available to those who are able to access it. We continue to believe unsecured credit represents a viable alternative to other credit options, and is appropriate where a retailer has a minimum level of credit worthiness, for example by having an investment grade credit rating. Further, we propose

that the market codes allow wholesalers to review the availability of unsecured credit if the circumstances of individual retailers change over time.

- We note that there are issues to be resolved around the requirements that should be placed on providers of some forms of credit – for example letters of credit, guarantees and insurance and the requirements on those parties providing such forms of credit. We consider that these issues are of an operational nature and should be resolved through the market codes, and so we will use a working group to resolve these issues.
- In reaching our decisions we have taken account of the market in Scotland, including WICS' recent consultation on credit arrangements in the Scottish retail market. We note that the consultation is still open and that the position in Scotland is therefore subject to change as a result of that consultation process. However, the different characteristics of the English/Welsh and Scottish markets provides a justification for using a different approach to that of WICS. For example, the Scottish market only has one wholesaler and does not have a range of credit options available to retailers. We therefore consider that the differences in credit and collateral requirements are reasonable and will not jeopardise the Anglo-Scottish market.

Decisions

Given the broad support in the responses and the greater flexibility from providing a range of credit options we continue to consider that the codes should specify a menu of different credit options including the unsecured credit option. To provide even greater flexibility we consider that there is merit in adding a seventh 'negotiated' credit option, albeit that where this is used wholesalers should face a requirement to publish the terms of that agreement to increase transparency and help to ensure a level playing field. We do not consider that wholesalers should necessarily be required to publish these agreements in full, as this could potentially raise commercial confidentiality issues as well as potentially exposing retailer positions. All companies have competition law obligations to comply with, and having taken into account responses, we think this provides sufficient safeguards such that only the terms of these arrangements should be disclosed.

Key decision 3 – Within the regulated credit arrangements for the retail market set out in the wholesale-retail code we expect a range of options to be provided that are available to retail entrants. This should include pre-payment (acknowledging that this is not strictly a 'credit' option in reality), cash security account, letter of credit, third party guarantee, insurance and unsecured credit based on the requirements set out in appendix 2. Retailers should be free to choose from any of these options and wholesalers must accept them provided that retailers meet the criteria set out in the

codes. We have made some changes to the detail of how the credit terms will work for the purposes of the market codes, and these are set out further in Appendix 2.

Key decision 4 - Within the regulated credit arrangements for the retail market set out in the wholesale-retail code we expect there to be a negotiated credit option. This should allow retailers and wholesalers to agree alternative, bespoke negotiated credit terms where both parties agree to these. Where this option is adopted, wholesalers must publish the terms these agreements.

We agree with many of the points raised about the level of detail set out in the credit arrangements and that further detail on how these arrangements will operate in practice will support the efficient operation and administration of the market and minimise barriers to entry. Therefore, in parallel with this decision document, we have established a small and representative working group of wholesalers and retailers to consider a range of more detailed points around how the various credit arrangements work in practice, including those raised by respondents.

The group will not revisit any of the decisions set out in this document. Once this group have worked through some of these more detailed points, we will prepare a change proposal for the codes which we hope to take to the ICP meeting in September for inclusion in the codes.

Treating retailers in default

Retailers may serve business customers in a single region or in multiple regions. A default could therefore affect only one wholesaler, or multiple wholesalers. A retailer serving multiple regions may be in default with one wholesaler, but not in default with others. The other wholesalers may be unaware that the retailer is in default and therefore unaware of the default risk they face.

For this reason, and for the orderly operation of the market, we proposed to treat a retailer in default with one wholesaler as being in default with all wholesalers, and the credit support options in place would apply to all wholesalers affected. This is consistent with the proposed arrangements for Interim Supply.

We did not receive any challenge to our proposals that retailers in default with one wholesaler should be treated as being in default with all wholesalers. We have therefore decided to retain our consultation position.

Key decision 5 –Within the regulated credit arrangements for the retail market set out in the market arrangements code and wholesale-retail code, we expect that a

retailer in default with one wholesaler should be treated as being in default with all wholesalers.

2.4.2 Unsecured credit

Our proposal

One of the credit options set out in the consultation was that, in certain circumstances, retailers with lower credit risk may be able to access some unsecured credit, requiring them to provide less collateral. Under this 'unsecured credit' option, we proposed that retailers with different credit ratings and credit scores could access different levels of unsecured credit – our proposed 'scale' was set out in appendix 2 to our consultation and was based on the DCUSA arrangements with some adjustments.

Approved long-term credit rating			% Unsecured credit
S&P	Moody's	Fitch	
AAA, AA+, AA, AA-	Aaa, Aa1, Aa2, Aa3	AAA, AA+, AA, AA-	80
A+, A, A-	A1, A2, A3	A+, A, A-	40
BBB+	Baa1	BBB+	20
BBB	Baa2	BBB	19
BBB-	Baa3	BBB-	18
BB+	Ba1	BB+	17
BB	Ba2	BB	16
BB-	Ba3	BB-	15

Credit score cover percentage	
Credit assessment score	% unsecured credit
10	20
9	19
8	18
7	17
6	16
5	15
4	12.5
3	10
≤2	0

Key issues raised

There were a number of issues raised specifically about this option and how unsecured credit could be obtained, and at what level.

- Fourteen respondents, including two retailers, agreed that an investment grade credit rating was the most appropriate benchmark for assessing retailers for them to obtain unsecured credit.
- Some respondents queried the values in the proposed scale of unsecured credit that can be accessed under different credit ratings and scores and the extent to which those values and their profile are appropriate. For example, some respondents suggested that the allowances and thresholds proposed should step up clearly at investment grade (BBB-).
- One retailer noted that it was difficult to understand the steep gradation in allowances for unsecured credit between similar investment grade ratings, especially in comparison with a very narrow gradation between lower investment grade ratings and sub-investment grade. Both rating agency definitions and market pricing of bonds did not show that the change in credit quality follows this pattern. The retailer also found it difficult to understand why a retailer should be given an allowance of less than 100% for a AAA credit rating, given the agency definition of AAA (S&P defines this as “extremely strong capacity to meet financial commitments”.
- The same retailer stated that Ofwat’s approach to the credit ratings of all licensees (both wholesalers and retailers) must be consistent, noting that Ofwat requires wholesalers to maintain an investment grade rating, but does not specify that this should be at any particular level.
- One retailer considered that an investment grade rating is not an appropriate reflection of the creditworthiness of water retailers. They considered that an investment grade credit rating is a financial indicator designed to signal to potential investors the relative risk of debt securities, such as bonds. It is not designed to reflect a company’s propensity to default on its trading payments. This is the role of trade credit scores, which are specifically designed to identify organisations that are likely to fail or pay late. The Dunn and Bradstreet Failure Score, for example, looks specifically at the likelihood that a company will cease operations over the next 12 months.
- One wholesaler suggested that an A- credit rating should be required and if the retailer is unable to satisfy this then alternative credit options would need to be used.

Evaluation

We agree with the points raised in the consultation that the unsecured credit scale may not be appropriate and in particular that:

1. The scale should take greater account of the difference between an investment grade credit rating and other ratings – there should be a greater

step up at this point in relation to the amount of unsecured credit that is available; and

2. There should also be an ability to provide a credit score as a means of securing unsecured credit as an alternative to investment grade rating (for example, for retailers who are unable to access an investment grade rating) and that there needs to be a clearer correlation between credit ratings and scores and the access to unsecured credit.

Based on the concerns raised we have revisited our approach. We also note the concerns raised that the use of an investment grade rating is not an appropriate reflection of the creditworthiness of water retailers as ratings are designed to signal to potential investors the relative risk of debt, and it may be reasonable to conclude that retail companies will not be heavily debt financed. We have also noted the suggestion that credit scores may be a more reasonable basis to assess potential financial failure of retailers, given that is a measure of payment history. For these reasons, we have revisited the thresholds associated with obtaining unsecured credit via both credit ratings and credit scores.

We continue to consider that creditworthiness is a relevant measure for determining the amount of unsecured credit retailers in the new business market should be allowed access to under the wholesale-retail code. And we acknowledge that there are several proxies for creditworthiness that exist, and there are several relevant scenarios that the credit arrangements could take into account. These are retailers who are:

1. Investment grade rated;
2. Sub-investment grade rated;
3. Unrated; and
4. Holding credit scores instead of a rating.

We discuss each of these scenarios below. In considering each scenario, we have adopted the principles of **simplicity**, **consistency** and **the creation of appropriate incentives**. As set out above, one of the key themes emerging from the consultation responses was that the original proposals were overly complex.

Investment grade credit ratings

We have first considered the case of retailers with an investment grade credit rating in their own right. Given that a guarantee from a third party from an investment grade entity could provide a guarantee for 100% of credit under the proposed guarantee option, it may seem inconsistent that an investment grade credit rating held by the retailer itself would be able to provide less than this under the proposed unsecured credit option (which in the consultation had a range from a maximum of 80% down to 18%). In addition to being inconsistent, it may also potentially create inappropriate incentives for retailers to create unusual structures to get around this anomaly – some retailers with investment grade credit ratings could potentially structure themselves in a way that would enable the issue of a guarantee that could cover 100% of credit. We do not consider that the unsecured credit option and the third party guarantee should be considered the same, in particular as the latter provides wholesalers with a guarantee for the sums involved. While this guarantee could come from another part of the same group, for example a parent company, the company will need an investment grade credit rating and the guarantee would impose credit costs on the retailer (unlike the unsecured credit option). Consequently we do not consider that unsecured credit and the parent company guarantee should cover the same proportion of a company's credit requirements.

We have also considered whether the credit allowance for all investment grade credit ratings, that is all ratings at or above BBB-/Baa3, should be the same. To inform this we have considered the 1-year probability of default across the different credit ratings, which is set out in the table below.

Table 1: 1-year default probability by rating category

%	AAA	AA	A	BBB	BB	B	CCC/C
S&P (2014): weighted long-term average	0.00	0.02	0.07	0.20	0.76	3.82	25.27
Elton (2001): Moody's	0.00	0.00	0.00	0.10	1.59	8.90	22.05
Elton (2001): S&P	0.00	0.00	0.10	0.21	1.21	5.90	22.53

Source: Elton, 2001, Explaining the Rate Spread on Corporate Bonds, The journal of finance, volume 56/1, February 2001. Standard and Poor, 2014, Annual Global Corporate Default Study and Rating Transitions.

Based on the above, we do not see strong evidence to differentiate within investment grade ratings; the change in the 1-year default probabilities within investment grade ratings are negligible (ratings AAA to BBB in table 1). We then see a jump between investment grade and sub investment grade (BBB to BB), with further jumps below this. We therefore consider that there is strong evidence that all investment grade rated companies should be treated the same. This would also aid simplicity and avoid the creation of a false impression of an accurate basis for differentiating between different ratings. It is also important to note that these arrangements will be a starting point for market opening, and the industry will therefore have the opportunity to propose amendments to the arrangements after market opening.

We have then considered what would be the appropriate proportion of credit that could be unsecured. In the consultation document we proposed an upper bound of 80% which reduced to 18% for the lower end of investment grade ratings. We consider that a figure towards the mid to lower end of this range should be used as water companies are unlikely to have the top end of investment grade credit rating. We have therefore decided to set the maximum proportion of unsecured credit to 40% across all investment grade credit ratings.

Sub-investment grade credit ratings

We have then considered whether unsecured credit should be provided for sub-investment grade ratings. Based on Table 1 sub-investment grade rated companies are around 5 times as risky as investment grade rated companies. This could indicate that we should allow reduced amount for the higher rated sub-investment grade rated companies, say 5 to 10% of total credit. However elsewhere in the regulatory regime and in the credit requirements we have an absolute requirement for companies to be as a minimum investment grade. Furthermore if retailers are not able to obtain an investment grade rating then they could still have access to unsecured credit by obtaining a credit score. We therefore do not consider that we should provide a specific allowance for sub investment grade rated companies.

Unrated retailers

Not all retailers will have (or be able to obtain) a credit rating. We consider that unrated retailers should be treated the same as those which are sub investment grade and we will not provide a specific allowance for unsecured credit.

Credit scores

The same principles around consistency, simplicity and incentives apply to the final scenario, of a retailer that obtains, a credit score.

We could take the view that a credit score of any level would provide 20% unsecured credit (as proposed in the consultation document). The use of 20% is supported in some way by precedent (DCUSA) and could be material enough to be the difference that helps retailers to finance themselves. Alternatively, we could allow a higher threshold if this could be justified and we were concerned that 20% would not be enough to ensure that sufficient creditworthy retailers could access finance.

In the DCUSA arrangements in the energy sector high credit scores of 9 and 10 out of 10 have been broadly equated to investment grade credit ratings. This could imply that credit scores of 9 or 10 should provide the same level of unsecured credit as investment grade rated retailers. However, as set out above, we have concerns with the way the DCUSA arrangements have been calculated. We have therefore considered the relative risk of default at high credit scores compared to investment grade credit ratings. According to the Dunn and Bradstreet rating guide[3] even companies with excellent credit scores can have 1 year failure rates of around 3%. This is similar to default probabilities for sub-investment grade credit ratings. However, we consider that credit scores are a meaningful way for assessing credit worthiness and that unsecured credit should be available for excellent credit scores given the difficult that some retailers may face in obtaining a credit rating.

We acknowledge that increasing the level of unsecured credit available to retailers with an excellent credit score could be seen as exposing wholesalers to a greater risk. However, we also need to take into account level playing field considerations, and that we do not want to foreclose the market to some types of retailers.

The mechanism for establishing a consistent approach for determining the creditworthiness of smaller entities has been the subject of much debate in other sectors. For example, Ofgem[4] considered the issues associated with this aspect of the credit arrangements in the energy sector and took the view that an unrated company does not necessarily pose a high risk of default – a rated entity could well be more likely to fail than a well-run and collateralised smaller company that is unrated. For this reason Ofgem sought to balance the likelihood and potential cost to consumers of the failure of unrated companies with the need for each unrated company to provide security.

On the one hand it can be argued that separating the payment record from the general assessment of creditworthiness focuses on a single and imperfect measure of creditworthiness. On the other hand the clarity of focussing on payment history gives a very sharp (and hence beneficial) incentive on unrated companies who opt

[3] D&B Rating Guide, 2012

[4] 'Best Practices Guidelines for Network Operator Credit Cover Conclusions document, Office of Gas and Electricity Markets, February 2005'

for this method, to pay their bills on time. Ofgem considered that this latter argument not only has merit but also can be expected to provide real benefits in terms of lower costs for network operators (wholesalers) both in chasing late payments and identifying financial difficulties at an early stage.

As with the other scenarios, we have decided that scaling should not be used. We are of the view that credit scores should adopt the same step-change approach as that used for ratings and that retailers who have a relative credit score of 9/10 out of 10 should be able to obtain around half the unsecured credit than an investment grade retailer, i.e, be able to obtain unsecured credit for 20% of the credit allowance. This is the same as the allowance provided under the DCUSA arrangements. For credit scores of 7/8 out of 10, we consider that a reduced allowance should be provided of 10% to provide retailers with an incentive to build up credit scores over time. We intend to use the same credit score scale as used in the DCUSA arrangements to set the relative scores of the different credit scoring agencies.

Decisions

Based on the responses received, we continue to believe that an unsecured credit option should be available to retailers and this should be available based either on a credit rating or a credit score. This will allow retailers, who may not be able to access a credit rating, the opportunity to access unsecured credit.

Therefore, based on the responses received, the evidence provided and taking into account the points discussed above, we have reviewed the allowances for unsecured credit available at different credit ratings/scores and have amended the original proposals in our consultation. These are set out in the tables below.

Key decision 6 - Within the regulated credit arrangements for the retail market set out in the wholesale-retail code we expect there to be provision for an unsecured credit allowance and that this should be based on the amounts set out in the tables below. This is also set out in appendix 2.

Approved long-term credit rating			% Unsecured credit
S&P	Moody's	Fitch	
AAA, AA+, AA, AA-	Aaa, Aa1, Aa2, Aa3	AAA, AA+, AA, AA-	40
A+, A, A-	A1, A2, A3	A+, A, A-	40
BBB+	Baa1	BBB+	40
BBB	Baa2	BBB	40
BBB-	Baa3	BBB-	40
BB+	Ba1	BB+	0
BB	Ba2	BB	0
BB-	Ba3	BB-	0

Credit score cover percentage	
Relative credit assessment score (out of 10)	**% unsecured credit**
10	20
9	20
8	10
7	10
6	0
5	0
4	0
3	0
≤2	0

2.5 A wholesale risk-sharing mechanism

Our proposals

Following our proposal to require retailers to provide 50 days of collateral to wholesalers in the market, it would be possible to further allocate some or all of the residual risk of retailer default that sits with the wholesaler to end customers via some form of additional wholesale risk sharing mechanism.

Risk sharing mechanisms are already in use in the water sector in England and Wales, and in other markets elsewhere (we discussed precedents for such mechanisms in appendix 4 to our consultation. In water, general risk sharing mechanisms such as outcome delivery incentives, revenue corrections (true-ups) and adjustments to price caps in-period (re-openers) already allow appointed companies to share some risks and rewards with customers. Indeed, as part of the 2014 Price Review, a number of companies proposed different risk and reward sharing mechanisms which we considered against a series of tests in our assessment of business plans.

The specific form of risk sharing we considered for the new retail market in our consultation would be designed to work alongside the existing credit arrangements and enable the risks related to retailer default to be shared among market participants (retailers, wholesalers and customers) in certain circumstances. Such a mechanism could, in the event of a retailer default, allow the wholesaler recourse to Ofwat to either re-open its wholesale price limits in-period or receive a true-up to its price limits at the end of the price control period where the retailer had outstanding debts to the wholesaler that were not adequately covered by the collateral provided via the credit arrangements.

Based on our analysis, which suggested that this level of risk would not have a material impact on wholesalers even in the event of a significant default, we did not consider that such a mechanism should be required. However, we invited views from stakeholders about whether such a mechanism would be appropriate now ahead of PR19, particularly given the residual risk being placed on wholesalers and appendix 4 of the consultation also outlined our view of how such a mechanism could work, if one were to be implemented.

Key issues raised

13 respondents – 10 out of 14 wholesalers and three out of seven retailers (three were silent on this issue and the other agreed with our proposal) suggested that, counter to our proposals, a wholesale risk sharing mechanism should be included.

The key points raised in support of a risk sharing mechanism are set out below.

- A concern that the debt risk of retailer default on the wholesaler is one that was not envisaged in PR14 and so was not considered in the risk and reward assessment or the resulting PR14 cost of capital that was carried out at the time and that therefore a wholesale risk sharing mechanism is appropriate as wholesale risk is increasing.
- A suggestion that the introduction of a risk sharing mechanism would provide the most efficient mechanism for the allocation of risk and reward should a retailer default as the risk is infrequent but potentially high impact, and pricing retailer default either into wholesale or retail costs is inefficient for customers and ineffective or administratively expensive for the market.
- It is more effective for wholesalers to recover losses that are actually incurred as a result of retailer default through price controls rather than imposing a significant 'insurance' cost on retailers to cover costs which the wholesaler might incur.

Some of the key points raised against a risk sharing mechanism are set out below.

- A suggestion that a risk sharing mechanism is not required given the credit terms proposed, the relatively low materiality of any default and the existence of alternative mechanisms for remedies.
- That the existing reopener mechanisms can still be exercised and should be sufficient.
- That such a mechanism would add significant additional complexity at this time that was not justified by the likelihood of the risk crystallising.

- A concern that a wholesale risk sharing mechanism would transfer a proportion of the risk of retailer default to customers when they have no ability to manage this risk.

During the consultation, the rating agency Moody's also published a sector comment on 22 July. It stated:

> "We reflect on the following key credit considerations:
> - The introduction of competition will expose wholesalers to the credit risk of a potentially limited number of retail counterparties.
> - Non-household retail competition may produce potential maximum revenue losses comparable to current average bad debt levels.
> - A later opening of the household market to retail competition could significantly increase potential losses for wholesalers. However, retailer defaults in related sectors, specifically UK energy and Scottish water, have to date been limited.
> - Ofwat's proposed credit terms and collateral arrangements provide strong risk mitigation for wholesalers; however, retailers would face additional costs that could erode their margins." Moody's, 'UK Water Sector, Ofwat consults on wholesale-retail credit terms', p.1

Decisions

Based on the evidence provided, we will not introduce a risk sharing mechanism at this time. Our analysis suggests that, even in a worst case scenario, the impact on wholesalers would not be of such significance as to threaten their financeability and the evidence and responses from stakeholders appears to confirm this, given the levels of collateral provided by retailers, especially for the period up to PR19. We also recognise that such a mechanism would be complex to implement and consider that it is unnecessary at this time in light of the existing risk sharing mechanisms available – wholesalers can already seek recourse to the regulator to re-open or true-up price limits in certain circumstances, for example through Interim Determinations. These mechanisms, whilst not specifically designed for this purpose, should be sufficient to address any issues including retailer default that may threaten the financeability of an efficient wholesale business.

Key decision 7 – We will not introduce a wholesale risk sharing mechanism, but will review credit arrangements after the market is open

We note that many stakeholders have raised additional concerns or suggestions in relation to the detailed proposals around how any wholesale risk sharing mechanism would work. Since we do not propose to take a wholesale risk sharing mechanism forward at this time, we have not considered those concerns here but we will revisit those responses in the future if, after the market opens, such an arrangement is appropriate.

3. Next steps

We recognise that the credit terms are an important gap in the current market arrangements and many respondents wanted us to resolve the outstanding issues with the arrangements swiftly. Indeed, this was an overwhelming theme emerging from the responses received to the question around next steps in the consultation.

Implementing these credit arrangements will principally require the updating of the 'codes', including the Wholesale-Retail Code and the Market Arrangements Code that are available in draft form on the Open Water website and are governed by the Interim Code Panel which makes recommendations to Ofwat that we must then accept or reject. These codes already include some draft provisions to allow for different forms of credit (see sections 8-9 (part D) of the Business Terms, schedule 8 of the Market Arrangements Code and section 4.13.2 of the Market Terms document).

We will develop a change proposal for the codes and discuss that proposal with the Interim Code Panel in September based on this policy statement. Where we have set out decisions in this document we are unlikely to approve recommendations for change from the ICP that run counter to those decisions. Before that, and following discussion with the Interim Code Panel, we have established a working group of three wholesalers and three retailers to provide further detail on areas of the credit arrangements, including on the issues raised by respondents to the consultation, such as:

- The appropriate level of discretion for wholesalers and retailers under each option/how much detail of the process in each instance should be prescribed in the codes;
- How each of the options interact with each other and how retailers may transition between the different options;
- Whether standard templates for some options – e.g. letters of credit and PCG's are included within the codes;
- The '50 days of collateral' needs to be defined clearly in the market codes – for example, when does the time period begin and is it on a definitive or predictive basis; and
- How prescriptive the market codes should be.

The sub-group will not consider the thresholds associated with unsecured credit or the decisions set out in this document. Stakeholders will be able to review and comment on the detailed arrangements via their representative on the Interim Code Panel.

Appendix 1 List of respondents to our consultation

Affinity Water
Anglian Water
Clear Business Water
Portsmouth Water
Northumbrian Water
Severn Trent Water
Wessex Water
Kelda Retail
South Staffordshire Water Business
South Staffs Water
United Utilities
Southern Water
Castle Water
Anglian Water Business
Consumer Council for Water
Yorkshire Water
WaterPlus
South West Water
Thames Water
Business Stream
Bristol Water
South East
Dŵr Cymru

Appendix 2 Overview of different credit options

This appendix describes our approach for each of the credit options that will be included in the codes (in addition to the seventh 'by agreement' option). While we have included pre-payment in this Appendix, it is important to note that for the purposes of the market codes, this will be treated separately and as a complete alternative to post-payment options and credit cover. Retailers are also prohibited from using a mix of pre and post-payment options to provide the required collateral.

Cash Account

Description

Cash is the most secure form of collateral. It involves the retailer placing a defined amount in a secure bank account established by the wholesaler.

Key characteristics and assumptions

- The retailer will deposit funds into the account before the wholesaler supplies any water to the retailer. The amount deposited is enough to cover the next billing period.
- Balancing payments take place at the end of each billing period.
- The retailer is entitled to any interest generated by the account and must also be a potential recipient for funds from this account

Default provisions

- If the retailer defaults, the wholesaler can withdraw funds from the account.

Timings

- Funds are remitted on the day required.

Coverage

- The initial account balance is equal to 50 days of supply.

Recovery rate

- The recovery rate is assumed to be 100%.

Cost to retailer

- The cost of the working capital is assumed to be an indicative range reflecting retail cost of debt (4%) or a retail cost of capital (8%).

Letter of credit (or similar instrument)

Description

A letter of credit is a financial instrument in which an issuing bank agrees to make a payment to the wholesaler if certain contractual conditions are not met by the retailer.

Key characteristics and assumptions

- The retailer will obtain an irrevocable standby letter of credit (or some equivalent form of collateral, e.g. a revolving line of credit, overdraft) from an issuing bank which holds an investment-grade credit rating.
- Banks may require a parent company guarantee or some other form of security, which may limit availability of adequate coverage for some retailers.

Default provisions

- In the event of default, the wholesaler applies to the bank for release of funds using a beneficiary statement.

Timings

- The issuing bank will make a payment under the letter of credit within two days (this is in line with arrangements in UK electricity).

Coverage

- The collateral provided by the letter of credit is equal to 50 days of supply.

Recovery rate

- This is assumed to be 95%.

Cost to retailer

- Opening costs to be borne by the retailer.
- The cost is assumed to be 300bps above one-month LIBOR over the amount secured.

Third party guarantee

Description

This option involves a guarantee of payment or performance of obligations of the retailer by a parent company. Typically a credit threshold is applied to the provider of the guarantee (the parent). Guarantees are less secure than cash as they carry the associated credit risk of the guarantor.

Key characteristics and assumptions

- The retailer will obtain a guarantee from a guarantor (e.g. parent company) before the wholesaler commences supplying water to the retailer.
- The guarantee must cover the payment obligations on the retailer under the market framework arrangements and must also cover the cost to the wholesaler of any recovery of unpaid wholesale charges.
- The guarantee should define the minimum investment grade credit rating for the guarantor.
- The guarantee must be legally enforceable in GB. For guarantors registered outside of GB, a counterparty may be required to provide a legal opinion of enforceability. The country of residence of the guarantor must have a specified sovereign credit rating. The guarantor will be subject to the same credit scoring process as the counterparty.

Default provisions

- In the event of default, the wholesaler applies to the guarantor for release of funds.

Timings

- Funds are remitted by the guarantor within five business days.

Coverage

- The guarantee must cover an amount equal to 50 days of supply.

Recovery rate

- The recovery rate is assumed to be 95%.

Cost to retailer

- The cost is assumed to be the retail cost of capital minus risk-free rate x level of collateral.

Insurance

Description

This option involves a surety bond issued by an insurance company on behalf of a retailer, guaranteeing the performance of the retailer's obligations. Surety bonds are not one-size-fits-all financial instruments and can be tailored to the specific circumstances of the retailer and wholesaler. They can be bank-backed or insurance-backed bonds.

Key characteristics and assumptions

- The insurance instrument is obtained by the retailer to ensure the wholesaler is paid.
- The insurer should meet minimum credit rating requirements.
- Can be negotiated between the parties acting reasonably.

Default provisions

- The wholesaler can make a claim to recover losses if the retailer fails to meet its obligations.
- If the claim is valid, the insurance company will pay reparation that cannot exceed the surety bond amount.

Timings

- In the event of a claim, it is assumed that settlement will occur within 30 days.

Coverage

- The insurance is assumed to cover an amount equal to 50 days of supply.

Recovery rate

- The recovery rate is assumed to be 95%.

Cost to retailer

- The annual cost is assumed to be 5% of the value of the bond.

Unsecured credit allowance

Description

This option consists of an unsecured allowance as a proportion of otherwise collateralised charges and liabilities. The amount of the allowance is usually calculated based on the financial standing of a retailer (i.e. their creditworthiness) or their history of making full and timely payments.

Key characteristics and assumptions

- The retailer provides the wholesaler with a credit or trade rating. Depending on the rating, the retailer is then entitled to a portion of unsecured credit.
- Where participants do not have an approved credit rating, an unsecured credit allowance can be achieved through an independent credit assessment or through good payment history.
- The unsecured credit limit assigned to a user can be based on the credit strength of a parent guarantor.
- The wholesaler may not recover the proportion of charges which are unsecured.

Coverage

- Any shortfall in unsecured credit must be made up for through other approved credit support options.

Recovery rate

- The wholesaler will not recover the unsecured portion of the charges.

Timing of recovery

- For any charges that are secured, timings will be the relevant ones for each option.

Cost to wholesaler

- The cost to the wholesaler is the working capital impact of allowing the applicant to pay in arrears. This can be assumed as the wholesale cost of debt (3%).

Allowances for unsecured credit

Credit ratings and the associated percentages of unsecured credit available to retailers are set out in the tables below.

Approved rating unsecured credit cover percentage			
Approved long-term credit rating			% Unsecured credit
S&P	Moody's	Fitch	
AAA, AA+, AA, AA-	Aaa, Aa1, Aa2, Aa3	AAA, AA+, AA, AA-	40
A+, A, A-	A1, A2, A3	A+, A, A-	40
BBB+	Baa1	BBB+	40
BBB	Baa2	BBB	40
BBB-	Baa3	BBB-	40
BB+	Ba1	BB+	0
BB	Ba2	BB	0
BB-	Ba3	BB-	0

Credit score cover percentage	
Credit assessment score	% unsecured credit
10	40
9	40
8	10
7	10
6	0
5	0
4	0
3	0
≤2	0

Pre-payment

Description

A prepayment involves payment in advance by the retailer of the estimated cost associated with delivering a service by the wholesaler. In addition, a balancing payment is required once the actual cost of providing the service is known. Unlike cash on deposit, under pre-payment the monies pre-paid to the wholesaler immediately accrue to the wholesaler, however the wholesaler may still have a requirement to fund working capital, depending on the timings of its payments to suppliers.

Key characteristics and assumptions

- Before the wholesaler provides any services, the retailer pays an estimated billing period charge to the wholesaler.
- A balancing payment is required to reconcile the estimated charge and the actual charge. This may be to or from the wholesaler.
- The requirement pre-payment is estimated in advance for each billing period.
- No interest is payable by the wholesaler to the retailer.

Coverage

- The pre-payment is equal to 100% of the billing period.

Recovery rate

- The recovery rate is assumed to be 95%.

Default provisions

- In the event of default, the wholesaler is already covered, as default occurs in advance of the wholesaler providing any service to the retailer. It is assumed that default occurs at midnight on the day pre-payment is due.

Timing of recovery

- For the covered funds, recovery is immediate, as the wholesaler is already in possession of the funds.

Cost to retailer

- The cost of the working capital is assumed to be an indicative range reflecting retail cost of debt (4%) or a retail cost of capital (8%).

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Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

Phone: 0121 644 7500
Fax: 0121 644 7533
Website: www.ofwat.gov.uk
Email: mailbox@ofwat.gsi.gov.uk

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