June 2016

Trust in water

Credit terms between wholesalers and retailers in the new retail market – a consultation

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Ofwat

About this consultation

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 in April 2017. In 2014, the UK Government put in place legislation to facilitate the introduction of competition into the water and wastewater retail market for these customers. This new market will be the largest retail water market in the world and is expected to deliver around £200 million of overall benefit to customers and the UK economy.

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 retained the existing regulatory framework as the mechanism to ensure that customers receive first class, value for money, water and sewage services and to deliver its integrated water and sewage policies as set out in the Water Strategy for Wales. 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.

This consultation considers the credit arrangements between wholesalers and retailers in the new business retail market. These arrangements are part of our work on the Open Water programme. However, there are also important linkages to how price controls are set and our Water 2020 programme. We are seeking the views of all interested parties to share, and gather feedback on, our preferred approach.

We intend to set out our finalised proposals in a decision document in July 2016. We will then seek to take these proposed changes through the Interim Code Panel in August and, if appropriate, changes would also be reflected in the methodology for the 2019 Price Review (PR19) which we intend to publish in 2017.

We note that the UK Government has asked Ofwat to advise on the benefits and costs of extending choice and competition to residential customers. No decision or recommendation has yet been made and it should not be assumed that any credit arrangements for the business retail market would necessarily be implemented similarly for any residential retail market framework.

Consultation questions

Q1 Do you have any concerns with our approach or the assumptions used in the analysis of working capital and collateral costs under different credit options? Could our analysis be improved?

Q2 Do you have any comments or concerns with our analysis of the potential impacts of different credit options against net retail margins or the conclusions from that analysis?

Q3 Do you have any comments or concerns with our analysis of the potential wholesale impacts from a major retail default or the conclusions from that analysis?

Q4 Does our proposed approach of requiring retailers to provide wholesalers with 50 days of collateral through the credit arrangements represent an efficient allocation of risk? Please provide evidence to support your answer.

Q5 Do you support the inclusion of the six credit options set out in chapter 2?

Q6 Are there any changes to the proposed credit options that you consider are required and if so why? Is any further detail required in the credit arrangements for inclusion in the codes?

Q7 Is investment grade status the right threshold for assessing retailers in order for them to obtain unsecured credit? If not is there a better alternative that we should consider?

Q8 What is the minimum creditworthiness that should be required from a third party guarantor?

Q9 Should Ofwat introduce a seventh credit option? What are the risks and benefits of such an option?

Q10 Do you consider that a wholesale risk sharing mechanism should be introduced for the business retail market? Why do you consider this and what evidence can you provide to support this position?

Q11 What could be the potential impact of wholesale risk sharing on new entrants and market competitiveness?

Q12 If a wholesale risk sharing mechanism were introduced, how should it interact with the proposed credit options?

Q13 We welcome your views on the specific features of a risk sharing mechanism (should one be introduced), covering: triggers, materiality, justification and evidence, coverage, exclusions and caps, burden of recovery, timings, process, administration and order of recovery and practicality and costs

Q14 Do stakeholders have any concerns with our proposed next steps and timescales for resolving the outstanding credit arrangements?

Responding to this consultation

We welcome your responses to this consultation by close of business on **7 July 2016**.

You can email your responses to water2020@ofwat.gsi.gov.uk. You can submit your responses by post to:

Credit consultation
Water 2020
Ofwat
21 Bloomsbury Street
London WC1B 3HF

Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FoIA), the Data Protection Act 1988 and the Environment Information Regulations 2004.

If you would like the information you have provided to be treated as confidential, please be aware that, under the FoIA, there is a statutory 'Code of Practice' with which public authorities must comply and which deals, among other things, with obligations of confidence.

In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, in itself, be regarded as binding on Ofwat.

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Executive summary

At present, only a limited number of business, charity and public sector customers across England and Wales can choose their retailer. Following new legislation put in place by the UK Government, all eligible customers in England will be able to choose their retail supplier from April next year. 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.

Credit terms are an important aspect of the new market arrangements and seek to manage the financial risks of retailer default in the new market. In particular we need to ensure that:

The credit and collateral arrangements in the new market represent a fair and efficient allocation of risk – we are seeking to introduce a set of regulated credit and collateral arrangements to support the retail market, given the market power of wholesale incumbents in any negotiation over these terms and the incentive and opportunities that they may have to create barriers to entry into that market. In an effectively competitive market where multiple buyers and sellers exist, we would expect some risk sharing to be agreed between the two parties. We want to try and mimic this competitive market arrangement and provide an efficient allocation of this risk.

In seeking to meet this overarching objective we also need to be mindful of balancing:

1. **The need to ensure that the credit terms promote competition in the new retail market for the benefit of customers –** any disproportionate credit and collateral costs could act as a barrier to entry for new entrants with a chilling effect on the levels of rivalry and choice in the new market for customers.

2. **The need to ensure that credit terms allow wholesalers to remain financeable and mitigate undue costs from misallocation of risk and so continue to efficiently deliver the essential wholesale services customer rely on** – 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 financial viability of the wholesaler and the delivery of the essential water and wastewater services that customers rely on.

This consultation therefore sets out our proposed approach to the credit and collateral arrangements between wholesalers and retailers in the new business retail market. It considers two key sets of issues.

- **Our overarching policy objective of establishing an efficient allocation of risk** – the credit and collateral arrangements seek to manage the risks of a retailer defaulting in the new market. Through a variety of regulatory mechanisms it would be possible to allocate some or all of this risk to retailers, wholesalers and customers. This consultation firstly considers what the efficient balance of risk might be in light of the objectives we are seeking to achieve and the corresponding benefits to end customers in terms of enhanced levels of rivalry in the competitive environment, less administrative cost and security and resilience in the provision of wholesale and retail services.

- **How we could implement a solution that meets that objective, including:**

    - **The details of the credit support options set out in the market codes –** the new retail market will be supported by a set of 'codes', including the Wholesale and Retail Code (WRC) and the Market Arrangements Code (MAC) that are available in draft form on the Open Water website. These codes will define the processes and procedures for all interactions between wholesalers and retailers in the new market. They already include some draft provisions to allow for different forms of credit and these need further development. This consultation seeks to provide that additional detail based on the assumed allocation of risk.
    - **Whether, and if so how, a wholesale risk sharing mechanism should be introduced to supplement those credit arrangements –** in some other utility sectors, arrangements have been introduced that would allow wholesalers (or network businesses) a recourse to recover additional revenue through price controls in the event that a retailer defaults and goes into administration with outstanding debts owed to the wholesaler. We examine the potential case for such a mechanism in the water sector and how it could operate if one were taken forward.

In considering the form of the various credit arrangements and the appropriate balance of risk, we have sought to assess the impact of the different credit arrangements on wholesalers and retailers. This analysis essentially looks at the timescales over which collateral and working capital would be required based on the approach and timescales for billing, payment, settlement and interim supply, most of which are prescribed in the various market codes. It then also considers the likely cost of that working capital or collateral depending on the credit option that has been chosen.

We have set out the detailed approach to our analysis and the assumptions used in appendix 1. We welcome stakeholder views on this and any suggestions about how it could be improved.

The efficient balance of risk

The credit and collateral arrangements seek to manage the risks of a retailer defaulting in the new market. The costs of these new arrangements are made up of two different elements – a **working capital** element and a **collateral** element. Through a variety of regulatory mechanisms it would be possible to allocate some or all of this risk or cost to retailers, wholesalers and customers.

In the first instance, in considering where to allocate this risk we have reviewed the precedent arrangements in other sectors. In competitive markets, we might expect arrangements to evolve that would balance the protection of wholesalers against credit risk with attracting a range of retailers to provide service, and so would expect arrangements would reflect the need to protect wholesalers against undue risk, while at the same time not providing an undue barrier to the market.

In UK electricity and gas distribution under the Distribution Connection and Use of System Agreement (DCUSA) provisions, retailers provide 60% of the collateral arrangements and wholesalers are subject to 40% of these risks. We consider that this may represent an efficient balance of risk, and are proposing that retailers provide 50 days of collateral to wholesalers to cover the risk of retailer default (which represents around 60% of the total risk exposure under our modelling approach).

As part of our consideration of where to allocate this risk, we have also explicitly considered our objective 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. We have done this by:

- assessing the likely working capital and collateral costs to retailers of different credit proposals with reference to the impact on the net retail margins overall and for particular customer groups under different allocations of the risk of retailer default; and
- assessing the likely impact of a significant retailer default on a wholesaler, both as a one-off annual event and also as a probability-adjusted event over the 2017-20 period (i.e. taking some account of the likelihood of such an event based on the experience of retail or supply markets in other sectors), with and without different levels of collateral provided by the retailer.

Based on the feedback we have already received and the above analysis we consider that:

- The credit analysis we have undertaken could suggest that the existing 2.5% net retail margin should be sufficient to provide reasonable return for an efficient retailer;
- Nevertheless we are concerned that for some of the lower margin tariffs currently in place ahead of PR16 under certain credit options, there appears to be some risk that the margins may not be sufficient to cover the costs of working capital and collateral and that these regulated credit arrangements may tie up significant amounts of capital and could present a barrier to entry for that market; and
- Minor retailer defaults, of the sort experienced in the Scottish retail market and elsewhere, are more likely to occur but unlikely to have a material impact on wholesalers. That said, an extreme and significant retailer default could have a material impact on wholesalers unless sufficient credit collateral is provided by retailers.

Based on these conclusions we propose that retailers should be required to provide 50 days of collateral cover to the wholesaler.

We believe that this approach would a) provide an efficient balance of risk, b) promote competition in the retail market for the benefit of customers and reduce entry barriers to that market, c) avoid tying up capital in that market unnecessarily which would be inefficient and d) provide automatic cover for the majority of the risk associated with a retailer default. We consider that the residual risk represents an immaterial risk to a wholesaler under any of the various credit options.

The proposed credit arrangements for the codes

As set out above, the new retail market will be supported by a set of 'codes', including the WRC and the MAC. These codes will define the processes and procedures for all interactions between wholesalers and retailers in the new retail market. They already include some draft provisions to allow for different forms of credit and these need to be finalised imminently so that they can be implemented for the opening of that market next year.

This consultation seeks to provide that additional detail based on the proposed allocation of risk. It sets out six credit options that we propose to take forward to the Interim Code Panel for their potential inclusion in the codes. These proposed options have been selected as part of the work to date and are based on a number of engagements with stakeholders including an industry-wide consultation, workshops and dialogue with market participants and other stakeholders including banks and

rating agencies that have experience providing credit support across a range of sectors and companies. In addition, existing precedents in relevant markets have also been taken into account. These are set out in appendix 3.

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 propose 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. These six credit options are:

- **Cash:** Cash is the most secure form of collateral. It involves the retailer placing a defined amount into a secure bank account established by the wholesaler. The retailer will be responsible for depositing funds equal to 50 days of supply into the account before any service is provided by the wholesaler. In a case of default, the wholesaler will be able to withdraw from the account.

- **Letter of credit:** 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. The retailer will obtain an irrevocable standby letter of credit with a collateral coverage equal to 50 days of supply from a bank which holds an investment-grade credit rating. Banks in turn may require other forms of security, such as a parent company guarantee.

- **Third party guarantee:** This option involves a guarantee of payment or performance of obligations of the retailer by a parent company or third party guarantor. Under this option, the retailer is required to obtain a guarantee from a guarantor before any service is provided by the wholesaler. The guarantee must cover the cost to the wholesaler of any recovery of unpaid wholesale charges equal to at least 50 days of supply. A credit threshold is typically applied to the provider of the guarantee (the parent). As a result, guarantees are considered less secure than cash, as they carry the associated credit risk of the guarantor.

- **Insurance:** 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. Where a retailer defaults and a claim against the insurance is considered valid, the wholesaler will recover losses through an insurer, who will pay reparation that will not exceed the surety bond amount, equal to 50 days of supply.

- **Unsecured credit:** 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. 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 assessment or through the demonstration of good payment history with the wholesaler.

- **Pre-payment:** 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. 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.

Specific details of the individual features associated with each of the credit options are set out in appendix 2. We welcome any views from stakeholders on any aspects of these proposals and how they could be improved.

Based on stakeholder feedback we are also proposing to introduce an additional, seventh option that would provide more flexibility for participants to tailor credit arrangements to their specific needs and preferences without affecting the other six regulated options. This seventh option could take the form of a bilateral agreement, where terms would be negotiated by the parties. If both parties agreed to terms that were different from the six regulated options then these could be adopted. We consulted on a similar set of proposals for ‘non-standard’ terms in 2013 and concerns were expressed that allowing wholesalers to offer non-standard terms creates the potential risk that they could offer overly generous terms to their own retailers and so inhibit competition.

To limit this risk we propose that any non-standard credit terms agreed between any two parties, including between a wholesaler and its own retailer, must be published and made available to any other party with a similar level of creditworthiness. We welcome stakeholder views on this proposal.

A wholesale risk sharing mechanism?

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 discuss precedents for such mechanisms in appendix 3. 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 are considering for the new retail market 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 in the credit arrangements.

We do not consider that such a mechanism should be required. The analysis suggests that this level of risk would not have a material impact on wholesalers even in the event of a significant default, and companies already have a number of re-opener mechanisms within the existing framework that they could seek to use were such an extreme event to occur. In the future, once there is some experience with the operation of the market we may revisit this decision, for example during the 2019 Price Review (PR19). However, we welcome views from stakeholders about whether such a mechanism would be appropriate now ahead of PR19, particularly given the residual risk being placed on wholesalers.

To the extent that such a mechanism were introduced, we consider that it should only ever cover a proportion of the risk of retailer default. This would appear to be consistent with other sectors. As such, it would always need to work in conjunction with the other credit arrangements and would be used to replace, in part, the

collateral a retailer would normally be required to provide, thus reducing the costs to the retailer while maintaining protections for the wholesaler.

Were a risk sharing mechanism to be introduced, our proposed approach is set out in appendix 4. We welcome views on this proposed approach.

We are not proposing any changes to the conditions of water company appointments ("licences") to implement any wholesale risk sharing mechanism. If this were to be taken forward, then we consider that it could sensibly be implemented as a true-up mechanism in PR19.

Next steps

We welcome stakeholder views to this consultation document by **7 July 2016**. We intend to publish a decision document in July which will set out:

- the proposed credit arrangements for the codes, including the appropriate balance of risk, that we intend to put before the Interim Code Panel for their consideration and ratification; and
- whether the arrangements will include a wholesale risk sharing mechanism and if so, what form that should take.

Following the publication of that decision document, the Interim Code Panel will be free to consider the proposals in August and include the final credit arrangements in the codes ahead of the shadow market opening in October.

If a wholesale risk sharing mechanism were to be taken forward, Ofwat will set out its proposals for that mechanism as part of its methodology consultation on the 2019 Price Review in June next year and the methodology statement in December 2017.

1 Background and purpose

1.1 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. In 2014, the UK Government put in place legislation to facilitate the introduction of competition into the water and wastewater retail market for these customers. This consultation sets out our proposed approach to the credit and collateral arrangements between wholesalers and retailers in the new business retail market.

Credit terms are an important aspect of the market arrangements. 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 for 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 financial viability of the wholesaler and the delivery of the essential water and wastewater services that customers rely on. Finally, and perhaps 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.

In taking forward the development of the new credit arrangements, this consultation considers two key issues.

- **Our overarching policy objective of establishing an efficient allocation of risk** – the credit and collateral arrangements seek to manage the risks of a retailer defaulting in the new market. Through a variety of regulatory mechanisms it would be possible to allocate some or all of this risk to retailers, wholesalers and customers. This consultation firstly considers what the efficient balance of risk might be in light of the objectives we are seeking to achieve and the corresponding benefits to end customers in terms of enhanced levels of rivalry in the competitive environment, less administrative cost and security and resilience in the provision of wholesale and retail services.

- **How we could implement a solution that meets that objective, including:**

- **The details of the credit support options set out in the market codes –** the new retail market will be supported by a set of 'codes', including the Wholesale and Retail Code (WRC) and the Market Arrangements Code (MAC) that are available in draft form on the Open Water website and are governed by the Interim Code Panel. 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). The credit arrangements set out in these codes need further development, which is set out in chapter 2 of this consultation.
- **Whether, and if so how, a wholesale risk sharing mechanism should be introduced to supplement those credit arrangements –** in some other utility sectors arrangements have been introduced that would allow wholesalers (or network businesses) a recourse to recover additional revenue through price controls in the event that a retailer defaults and goes into administration with outstanding debts owed to the wholesaler. Chapter 3 of this consultation examines the potential case for such a mechanism in the water sector and we set out in appendix 4 how it could operate if one were taken forward.

In considering the answers to these questions we have conducted some analysis on the potential impacts of the different credit arrangements on both retailers and wholesalers. This has included considering the impacts against different net retail margins and the impacts on the wholesale business under different credit arrangements.

1.2 What we are trying to achieve

In designing the regulatory arrangements for the new retail market we are required to act in accordance with the strategic priorities and objectives set out by the UK and Welsh Governments, while always acting in accordance with our statutory duties[1].

Based on those statutory duties and the guidance we receive, we have developed some objectives for our regulatory work in relation to the opening of the new retail market[2]. These objectives are also consistent with our shared vision for the water

[1] The statutory framework for these duties is set out in full in S.2 of the Water Industry Act 1991 (as amended) (WIA91) – see http://www.legislation.gov.uk.
[2] These are set out on page 15 of our previous consultation on deemed contracts.

sector that customers and wider society have trust and confidence in vital public water and wastewater services. In particular we need to ensure that:

The credit and collateral arrangements in the new market represent a fair and efficient allocation of risk – we are seeking to introduce a set of regulated credit and collateral arrangements to support the retail market given the market power of wholesale incumbents in any negotiation over these terms and the incentive and opportunities that they may have to create barriers to entry into that market. In an effectively competitive market where multiple buyers and sellers exist, we would expect some risk sharing to be agreed between the two parties. We want to try and mimic this competitive market arrangement and provide an efficient allocation of this risk.

In seeking to meet this overarching objective we also need to be mindful of balancing:

1. **The need to ensure that the credit terms promote competition in the new retail market for the benefit of customers –** any disproportionate credit and collateral costs could act as a barrier to entry for new entrants with a chilling effect on the levels of rivalry and choice in the new market for customers.

2. **The need to ensure that credit terms allow wholesalers to remain financeable and mitigate undue costs from misallocation of risk and so continue to efficiently deliver the essential wholesale services customer rely on** – 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 financial viability of the wholesaler and the delivery of the essential water and wastewater services that customers rely on.

1.3 Background and interactions with other work

Ofwat has previously undertaken work through the 2014 Price Review (PR14) and the Open Water and Retail Market Opening programmes that is relevant to the consideration of potential credit and collateral arrangements between wholesalers and retailers. We are also currently taking forward work on the review of business retail price limits this year (PR16) and the development of the methodology for the 2019 Price Review (PR19).

PR14

In setting limits on the revenues that appointed companies can recover from their customers during the 2015-20 period, including the period from 2017-20 when the new retail market is expected to be open, we made a number of relevant assumptions:

- **Payment terms and working capital** – in 2013, we consulted on the proposed payment terms between wholesalers and retailers to allow prices to be set in 2014. Following that consultation, we issued an Information Note setting out the payment terms we would assume in PR14 and these were then represented in the final determinations and the associated financial modelling.

- **Retail margins** – similarly, as part of PR14, all appointed companies accepted that a new retail margin of 2.5% was appropriate for the business price control, reflecting that this would be opened up to competition from April 2017. In setting this margin we drew on work from PwC, which suggested that a margin in the range of 1-4% would be appropriate, as well as submissions from appointed companies which suggested a range of between 0.8%-5.3% for English companies. We set out our rationale for a 2.5% net margin in our Risk and Reward guidance that was published in January 2014.

- **Wholesale risk** – as part of our work on 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 in reaching these conclusions. We estimated an appointee cost of capital, which was decomposed into two components – (i) the wholesale cost of capital, and (ii) 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. The appointee cost of capital reflects non-diversifiable risks associated with bad debts at the retail level. There is no wholesale counterparty risk, however, the appointed business also faces risks around the operation of the retail business – such as poor returns, which would impact on appointee returns. It no longer faces these risks following the separation of the retail business. It is not obvious how these risks compare with counterparty credit risk, but if broadly equivalent, then this will be reflected in the wholesale cost of capital, as it has been derived from the appointee cost of capital less retail margins.

Open Water

Following the conclusion of PR14, further work was undertaken through the Open Water programme to define the settlement arrangements and credit terms and collateral arrangements that would be set out in the market codes for the new market.

- **June 2015 workshop** – in June 2015, Ofwat held a workshop that aimed to establish the appropriate credit arrangements for inclusion in the draft market codes. At that workshop the majority of participants, including retailers and wholesalers, new entrants and incumbents, expressed a preference for a menu of alternative credit arrangements to be regulated and set out in the codes to reduce barriers to entry into the new market. A summary note of the workshop was published on the Open Water website.

- **Baselined codes –** the WRC was updated following the June 2015 workshop to reflect the six credit options that were discussed prior to them being baselined and placed under formal change control via the governance of the Interim Code Panel[3]. The codes also critically include certain timelines and arrangements for financial settlement between wholesalers and retailers in the new market.

- **Withdrawal of the PR14 Information notice –** as the new payment and credit terms have developed, the original arrangements used for the setting of prices in PR14 have been superseded and the original Information Note has been removed.

- **2016 work** – a further stakeholder workshop was held in February 2016, where stakeholders had the opportunity to challenge the credit options and the analysis and assumptions around the associated risks. A summary note of the workshop can be found here. At this workshop the need for a further formal Ofwat consultation on these issues was emphasised leading to this publication.

PR16

The business retail price controls were set from 1 April 2015 for a period of two years – taking account of representations from water companies that there would be advantages in reviewing these arrangements before the market opens in April 2017.

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[3] 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

In November 2015, we published an initial consultation on this review and have subsequently published a draft statement of method in March which builds on our earlier consultation by setting out our current thinking on key issues and next steps, including the overall level of cost and margin allowances for the business retail price controls.

"At PR14, we based a margin of 2.5% in part, on consideration of the results of two sets of analyses set out in a recent PwC report…. This analysis suggested, using benchmarking, that an appropriate NHH retail net margin should be below 3.2% but above 1%.…PwC's analysis also found the need for a 0.4% net margin to cover the costs of NHH retailer's working capital requirements. Considering the six [credit] options…we estimate the increase in net margin requirement to cover working capital and credit costs is 0.35% under the prepayment option. We also note that the credit costs associated with insurance and letters of credit are more likely to be more costly than pre-payment. And we note that for the unsecured credit option, an overall reduction in the net margin by 0.27% would be appropriate. As retailers are able to select the option that is most favourable to them, we expect that the most expensive options will only be used by a sub-set of retailers entering the market – and not by entrants able to lever on economies of scope with other activities (and so offer cash deposits or appropriate guarantees) and established retailers and incumbents. Any additional costs may also be temporary as credit history is achieved. This suggests that there should be no general increase in credit costs and there is no compelling case to increase the allowed net margin of 2.5%." Ofwat, PR16 Draft statement of method and data table requirements, pp26-7

PR19

Ofwat will re-set price limits for the 2020-25 period in 2019 and intends to consult on the methodology for those price controls in the summer of 2017, with a final methodology statement in December 2017. This will also consider whether or not we need to continue to set price controls for these services beyond 2020. Any adjustments or true-up mechanisms for those price limits, including any wholesale risk sharing mechanisms for either the 2017-20 or the 2020-25 period, would need to be included in that methodology. This work is being taken forward through our Water 2020 programme.

In developing our proposals we have considered carefully the interactions with these other areas of work.

2 Potential credit arrangements for the new retail market

2.1 Introduction

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.

"The current system of negotiated access appears to represent a significant barrier, preventing competitors entering, and then participating in, the market. The experience of other sectors, including electricity and gas, has shown that regulated access is a prerequisite for large scale entry as it reduces the costs of entry and prevents non-price discrimination….The Government should amend the legislation to introduce nationally agreed operational codes and systems which would be binding for all market participants. Ofwat should act as coordinator, in conjunction with stakeholders." Cave, 2008, Independent Review: of competition and innovation in Water Markets.

"A future Water Bill will introduce a new, regulated approach to market entry and remove the need for a new entrant to negotiate terms with each of the 21 incumbent water companies across England, which has acted as a major barrier to entry." HM Government, 2011, 'Water for Life'.

This would help remove potential barriers to entry and provide certainty and transparency to new entrants that credit terms would be accepted by wholesalers who may have both the incentive and opportunity to restrict entry. We support this approach.

We also consider that, whilst regulated access is needed, there should be a range of options provided to enable some level of flexibility to support different preferences and business models amongst potential entrants. We have therefore set out to establish a number of options, offering different alternatives that are clearly defined and this broad approach was also supported by market participants at the workshop in June 2015.

Whilst not all retailers may be in a position to access each of the different arrangements, the options available should allow choice and efficient companies with greater creditworthiness may well be able to access more favourable terms.

2.2 Defining the appropriate credit arrangements under each of the different options

To define our proposed arrangements under each of the credit options we have sought to:

1. **Consider the appropriate balance of risk between retailers, wholesalers and end-customers** for these new credit arrangements in the associated judgement about the level of collateral that the retailer should provide to the wholesaler; and
2. **Develop the detailed terms under each of the proposed credit options** based on the details already set out in the draft codes, for example the timescales for settlement and payment, and the feedback from stakeholders to those details as well as the precedent arrangements in other sectors.

As part of our consideration of the balance of risk, we have explicitly considered the appropriate balance between our objectives of promoting competition in the retail market and minimising barriers to entry and expansion in that market and maintaining the financial stability of the wholesaler and the fulfilment of their essential functions. We have also considered the overall efficiency of the arrangements and the extent to which they tie up capital unnecessarily and create costs that would be passed on to customers.

We have done this by:

- assessing the likely working capital and collateral costs to retailers of different credit proposals with reference to the impact on the net retail margins overall and for particular customer groups under different allocations of the risk of retailer default; and
- assessing the likely impact of a significant retailer default on a wholesaler both as an one-off annual event and also as a probability adjusted event over the 2017-20 period (i.e. taking some account of the likelihood of such an event based on the experience of retail or supply markets in other sectors) with and without different levels of collateral provided by the retailer.

2.3 Assessing the appropriate balance of risk

In seeking to deliver these objectives, we need to consider the appropriate balance of risk and the associated costs of pricing that risk between retailers, wholesalers and customers under each of the different credit options. There are two different elements to these costs:

1. **The costs of working capital** – under the existing pre and post payment settlement arrangements that are set out in the codes and being implemented in the central system there are certain assumptions around timescales for billing, payment, default and interim supply. Whilst it would be possible to amend these arrangements, we have not heard any concerns with these arrangements raised by stakeholders and do not consider that this would be sensible given the potential impact on the development of the central system and the corresponding risk to the timelines for market opening.

   We have therefore assumed that these timescales are fixed and this effectively imposes a working capital cost on retailers and wholesalers under the different pre and post-payment settlement scenarios and different forms of credit that is static against the assumptions made in the analysis.

2. **The cost of collateral** – whilst the working capital elements are static against the settlement and other arrangements set out in the codes, it would be possible to amend the level of collateral that retailers are required to provide to wholesalers to cover the risk of retailer default, for example:

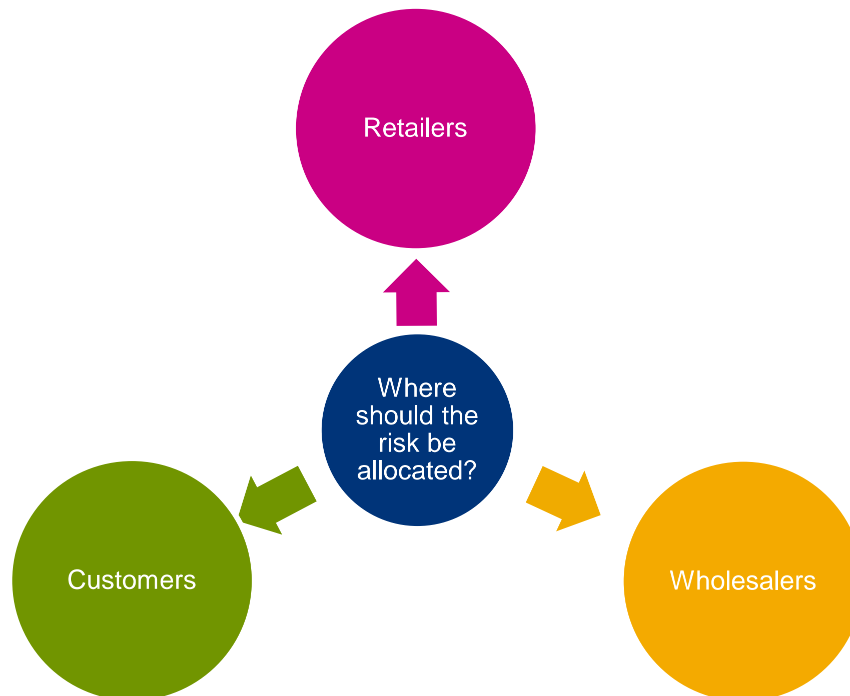
   - if retailers are required to provide sufficient collateral to cover 100% of the risk of their default to wholesalers through the regulatory arrangements in the codes then all of the risk will be allocated to retailers with corresponding impacts on the retailer in terms of costs and impact on net margins; and

   - if retailers are required to provide no collateral to cover the risk of retailer default then the wholesaler is in effect covering the risk of retailer default.

Hence, by varying the levels of collateral provided by retailers, it is possible to reallocate some of the risk of retailer default between wholesalers and retailers.

However, it is also possible to allocate some or all of this risk to end customers by allowing for a re-opening of price limits at the wholesale level in the event of a retailer default through the creation of a **wholesale risk sharing mechanism**. This would remove the cost of collateral on retailers and allow wholesalers to pass these costs on to customers in the event of retailer default through higher wholesale charges. We discuss wholesale risk sharing mechanisms further in chapter 3.

Figure 1: Assessing the appropriate balance of risk



Generally, there are likely to be strong arguments for allocating the risk of retailer default to retailers as retailers are likely to be those best able to manage the risk, and allocating some or all of this risk elsewhere might weaken the incentives to manage this risk effectively. However, the arrangements are largely regulated and so the ability of management teams to influence those arrangements, and therefore the corresponding effect on incentives, may be limited. Furthermore, we also need to consider what the efficient market allocation would be, which we should be seeking to mimic. In a market context where there were multiple wholesalers and retailers, it is unlikely that all of the risk would be allocated to the retailer and instead much more likely that at least some of the risk would be allocated to the wholesaler.

Similarly, allocating this risk entirely to retailers could tie up large sums of capital in the market for what are likely to be very rare events. In our analysis of the wholesaler risk, we have assumed that a material default is likely to be a one in twenty-year event based on precedents elsewhere. This could be seen as disproportionate and potentially limiting market entry.

If our analysis indicated that material negative impacts on levels of competition and rivalry in the retail market were likely under the proposed credit terms then it is possible that in those circumstances customers may be best protected by placing some of this risk with wholesalers, or indeed end customers. For example, if our

analysis of the cost of collateral against retail net margins suggested that there was a significant risk that these collateral costs could represent a significant barrier to entry into the market or prevent certain customers from participating in the market then it may be appropriate to re-allocate some of that risk elsewhere.

Finally, if our analysis indicated that, in the event of a significant retailer default against a given level of collateral, wholesalers were likely to be exposed to material risks that could affect their financial stability then this could suggest that customers may be best protected by placing some of the risk with retailers or indeed end customers. This analysis would need to consider the existing re-opener mechanisms that companies have available to pass such material risks on to end customers (for example, Interim Determinations (an IDoK) or Substantial Effect Claims).

2.4 Analysing the impacts under different risk allocation scenarios

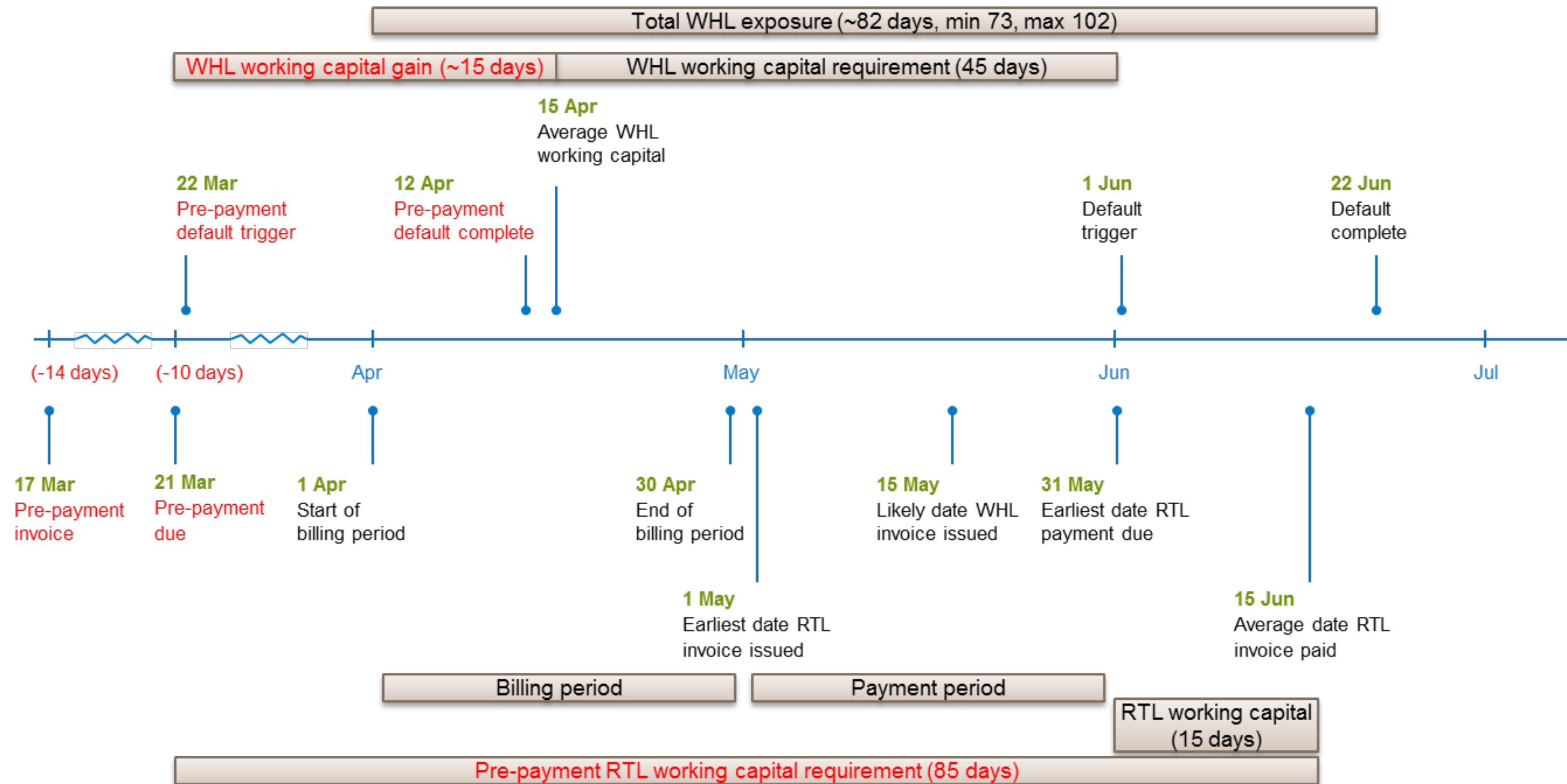
In order to identify the appropriate balance of risk we have assessed the impact of the proposed credit arrangements, including **a) working capital**, **b) collateral** and also **c) the impact on the wholesaler of a major retailer default**. Each of these impacts is largely dependent on the payment timescales between the parties and the level of collateral provided by the retailer under any selected credit option. We summarise the approach we have taken to each of these issues in our analysis below.

Payment timescales

The impact of different credit proposals will depend on the length of time between when the retailer pays the wholesaler in relation to the billing period. The timescales are different largely depending on which of the settlement arrangements are being used- pre-payment or post-payment.

Figure 3 shows two sets of timings – timings relating to **pre-payment** (where the retailer (RTL) pays the wholesaler (WHL) in advance of receiving supply) are shown in red; timings relating to **payment in arrears** (where the retailer pays the wholesaler after receiving supply) are shown in black. Calendar dates are used for ease of presentation, but most of the day totals are actually expressed as **business days** (not calendar days), so the timeline should be interpreted with this in mind.

Figure 2: Assumed payment timescales for credit analysis based on proposed settlement and interim supply arrangements



We have developed the payment timescales based on the timescales for billing, payment that are already established in the draft codes. We have also considered the timescales and arrangements established in the Interim Supply Code to understand the full potential exposure to the wholesaler under different options. The analysis also includes some assumptions about when retailers are likely to be paid by end customers and we provide below some illustrative examples of the assumed timescales. Further information on the assumptions used in our analysis can be found in appendix 1. The relevant timings can be illustrated in figure 4 (the calendar dates are used for illustration purposes only).

Figure 3: Illustration of timings used in our analysis

Payment in arrears - where no default occurs	• On 1 April the wholesaler commences supply for one calendar month. This ends on 30 April and is referred to as the billing period. At this stage, the wholesaler faces 30 calendar days of "exposure" to the risk of the retailer not paying. • After the end of the billing period, the wholesaler issues an invoice to the retailer. It is assumed that this happens, on average, by 15 May (as implied in the WRC). • The retailer pays the wholesaler by 31 May (the time from the end of the billing period to 31 May is referred to as the payment period). By this stage, the wholesaler faces 60 calendar days of exposure. • Meanwhile, it is assumed that the earliest time a retailer issues an invoice to an end customer is 1 May (the day after the end of the billing period). • The end customer pays the retailer, on average, on 15 June. The average days it takes an end customer to pay the retailer is assumed as 45 days (this is based on the calculations used for PR14, taking into account the fact that customer debtor days vary, and some customers are unmetered and pre-pay). • The retailer must therefore fund 15 days of working capital (from the date it pays the wholesaler to the date it receives payment from the end customer).
Payment in arrears - where default occurs	• A default trigger occurs on 1 June if the retailer has not paid by 31 May. • The retailer is then in default if it does not pay by 22 June. The WRC allows the retailer a maximum of 21 calendar days (15 business days) to pay after the due date. At this stage, the wholesaler faces 82 calendar days of exposure. • Once the retailer is in default, it is assumed that the Interim Supply process commences and at that point the liability for the wholesale

	service passes to the incoming retailer following a successful allocation process.
Pre-payment – where no default occurs	• On 17 March, the wholesaler issues an invoice to the retailer for supply for the following calendar month. • The retailer pays the wholesaler, in advance, by 21 March. • The wholesaler provides supply from 1 to 30 April. This is referred to as the billing period. • Meanwhile, it is assumed that the earliest time a retailer issues an invoice to an end customer is 1 May (the day after the end of the billing period). • The end customer pays the retailer, on average, on 15 June. The average days it takes to pay the retailer is thus assumed as 45 days (based on the calculations used for PR14, taking into account the fact that customer debtor days vary, and some customers are unmetered and pre-pay). The retailer must therefore fund 85 days of working capital (from the date it pays the wholesaler to the date it receives payment from the end customer).
Pre-payment – where default occurs	• A default trigger occurs on 22 March if the retailer has not paid by 21 March. • The retailer is then in default if it does not pay by 12 April. The WRC allows the retailer a maximum of 21 calendar days (15 business days) to pay after the due date. At this stage, the wholesaler faces 12 calendar days of exposure. • Once the retailer is in default, it is assumed that the Interim Supply process commences and at that point the liability for the wholesale service passes to the incoming interim retailer following a successful allocation process.

Level of collateral

The level of collateral required under any credit arrangement can be considered in terms of the percentage of the total exposure that the wholesaler may face in the event of retailer default. For example, if the up-front collateral provided by the retailer equates to 100% of the total charges that it has incurred, then in the event of default the wholesaler will not have incurred any increased debt. However, if the level of collateral required only covers 50% of the total exposure then the wholesaler will face a residual risk in the case of default depending on the extent to which it can settle the debt via an administrator.

The cost of that collateral will then vary depending on the form of credit through which it is provided. The assumed costs of that credit are set out in appendix 1.

Q1 Do you have any concerns with our approach or the assumptions used in the analysis of working capital and collateral costs under different credit options? Could our analysis be improved?

Assessing impacts on the retail market

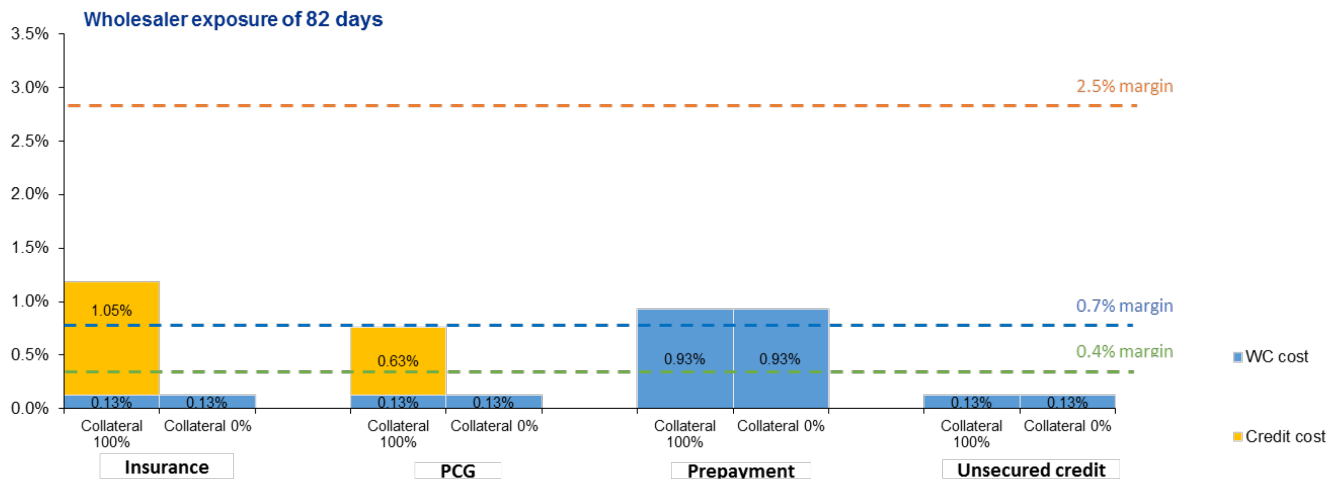
In order to assess the impacts on the retail market we have identified the overall costs to retailers and wholesalers from both working capital and the costs of collateral, assuming 82 days' maximum wholesale risk exposure against different costs of credit and working capital. Our assessment examines two scenarios, one where 100% of collateral was provided by the retailer to cover the risk of default and one where 0% was provided.

We have then assessed the impact of these costs against a range of benchmarks including the overall average net margin of 2.5% allowed in PR14 and the lowest (0.7%) net margins proposed by companies in their business retail default tariffs. We also assessed the cost of working capital against the 0.4% net margin requirement referred to in the draft method statement for PR16 based on PwC analysis.

Four credit options have been analysed to provide a range of scenarios from the 'highest cost' form of credit (insurance) to the 'lowest cost' (unsecured credit) as well as two more forms of credit (Parent Company Guarantees and pre-payment).

Figure 5 overleaf presents the analysis of each of these credit options against these benchmarks. Retail impacts are shown above the line; blue bars represent the costs of funding working capital and yellow the costs of funding collateral. Note that for pre-payment, the analysis assumes that retailers must fund not just the billing period, but an additional 22 days for the default period.

Figure 4: Potential impacts on retail margins



Overall we consider that the analysis, based on the assumptions used, suggests that:

- The average net margin of 2.5% that was set in PR14 appears sufficient to cover working capital and credit costs, even where the retailer is carrying 100% of the collateral for the risk of retailer default. Indeed, we have undertaken further comparative analysis of the credit and collateral requirements in some of the comparator markets that PwC considered in developing its 1-4% range of potential retail net margins and we do not believe that an approach where 100% of the collateral requirements were covered by retailers would be materially inconsistent with those alternative benchmarks.

- The analysis similarly broadly supports the previous PwC work during PR14 on working capital costs and the position in the draft method statement for PR16 is also consistent with this analysis.

- Nevertheless, analysis against the lowest net margin tariff bands may suggest that there is a significant risk that customers in those tariff bands may not be able to participate in the market. We also note that for some of these bands there is little difference between the net and gross tariffs.

- Under several of the options the working capital and credit costs will tie up capital in the market creating a potentially significant barrier to entry. This will be greater the higher the proportion of the default risk that we leave with retailers through credit and collateral costs.

The analysis of the impacts on retail net margins is indicative and it should not be used to infer, for example, that these tariffs represent a margin squeeze – much more information would be needed for this type of analysis. Nevertheless, companies with tariffs that represent very low net margins may wish to consider, on the basis of this analysis, whether those tariffs do accurately reflect the costs and risks associated with serving these customers ahead of PR16 Final Determinations once the credit arrangements have been finalised.

Q2 Do you have any comments or concerns with our analysis of the potential impacts of different credit options against net retail margins or the conclusions from that analysis?

Assessing wholesale impacts from a major retail default

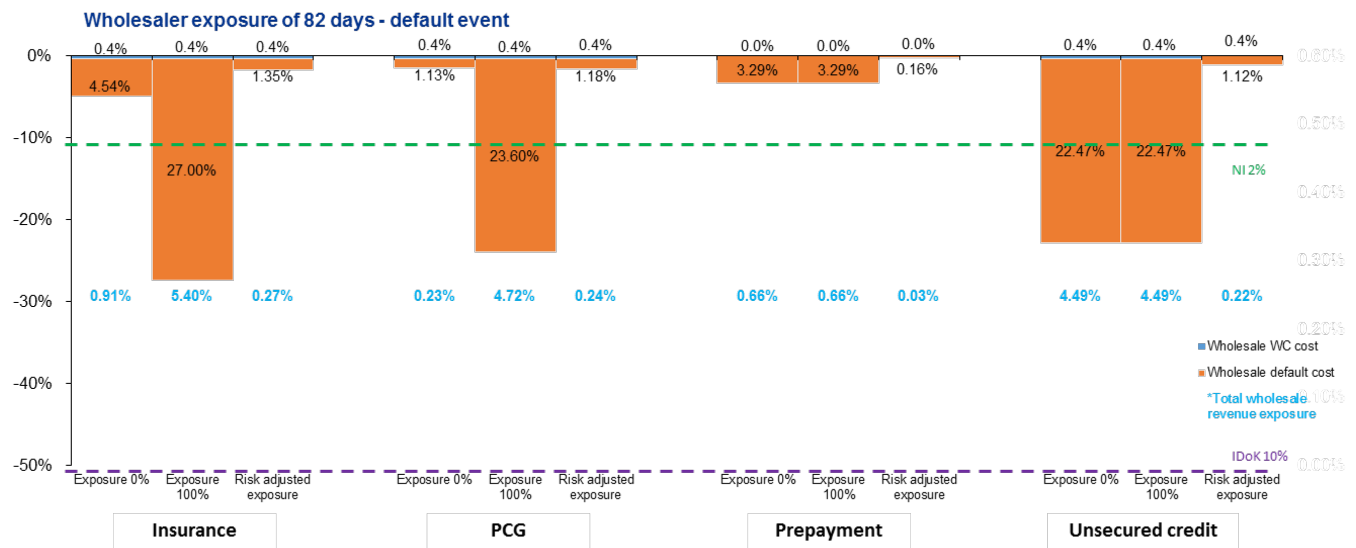
We then assessed the likely wholesale impacts from a major retailer default, i.e. a default where a retailer goes into administration that serves 100% of a wholesaler's non-household customer base. Our assessment once again examined two scenarios, one where 100% of collateral was provided by the retailer to cover the risk of default and one where 0% was provided. However, this assessment was done both on a risk adjusted basis (assuming a 1 in 20 year event for a major retail default) and a non-risk adjusted basis to identify the one-off effect.

We assessed these impacts against a range of benchmarks based around the existing re-opener mechanisms for price limits, including the 10% IDoK threshold and the 2% triviality threshold. This was designed to allow us to identify the materiality of a potential default on the wholesaler and the applicability of existing re-opener mechanisms to manage those risks.

Once again, four credit options were analysed to provide a range of scenarios from the 'highest cost' form of credit (insurance) to the 'lowest cost' (unsecured credit) as well as two more forms of credit (Parent Company Guarantees and pre-payment).

Figure 6 presents the analysis of each of these credit options against these benchmarks. Wholesale impacts are shown below the line; blue bars represent the costs of funding working capital and orange is the amount of default exposure. The first two bars under each option present the annual non-risk adjusted basis and the third the risk adjusted basis. Wholesale working capital costs have been calculated on the basis of a requirement to fund 45 days of supply; should a default occur, wholesalers may incur additional working capital costs that are not shown (for example, an additional 22 days for the 'default period').

Figure 5: Potential wholesale impacts from a major retail default



Overall we consider that the analysis, based on the assumptions used, suggests that:

- On a risk adjusted basis default risk is immaterial against existing materiality/triviality thresholds.
- However, in an extreme event, impacts could be material against some re-opener thresholds (but less than 10% IDoK threshold) unless suitably mitigated by credit arrangements by placing more of the risk and collateral costs with retailers.

We also note that:

- The precedent experience in other sectors suggests that, whilst small retailer defaults may be common – there has been one in Scotland since the market opened in 2008 and the impact of this was minimal (accounting for 0.08% of Scottish Water's wholesale charges) large scale retailer default is likely to be rare. The impact of defaults in the energy sector from 2000-2008 equates to 0.02% of wholesale revenues. We have assumed that this is a 1 in 20 year event based on the experience in other utility supply markets such as the UK energy supply market.

- We recognise that a number of existing appointees may wish to exit from their business retail obligations and either transfer these customers and perhaps some of the assets and staff used to serve them to another associated company or indeed undertake a trade sale of these activities to another company. Where appointed companies do undertake a trade sale to another retailer this may create a relationship between a wholesaler and a large single retailer serving the

vast majority of their customers increasing the risk of significant retailer default. In such instances we would expect that appointed wholesalers would seek to undertake appropriate due diligence in relation to the retailer in question. Such due diligence is entirely within the control of appointed management and key to mitigating the risk of significant retailer default impacts after the market opens.

Q3 Do you have any comments or concerns with our analysis of the potential wholesale impacts from a major retail default or the conclusions from that analysis?

Considering precedent in other sectors

We have similarly considered the precedent arrangements in other sectors and these are set out in Appendix 3. In reviewing those arrangements we have sought to identify what an appropriate or efficient balance of risk might be between the different parties especially since, in the absence of the market power of the wholesaler it is unlikely that all of the risk would be allocated to the retailer.

In reviewing those arrangements we have noted the interesting arrangements that exist in the energy sector. In UK electricity and gas distribution under the Distribution Connection and Use of System Agreement (DCUSA) provisions, wholesalers are able to recover up to 40% of bad debt through wholesale risk sharing reducing the allocation of risk to the retailer.

We consider that allocating around 60% of the risk to the retailer could be a more efficient allocation of risk, avoiding tying up unnecessary costs of collateral and making the market arrangements more efficient. In our analysis we have assumed that in the event of a retailer default in total wholesalers might incur 82 days of revenue risk 60% of this would represent 49.2 days.

Identifying the appropriate balance of risk

Based on the feedback we have already received and the above analysis we consider that:

1. A 2.5% net retail margin should be sufficient to cover working capital and collateral arrangements - we consider that at an aggregate level this should be sufficient to promote competition but we welcome views and evidence in response to this.

2. Nevertheless we are concerned that for some of the lower margin tariffs there appears to be some risk that these customers may not be able to participate in the market and we are concerned that these regulated credit arrangements may

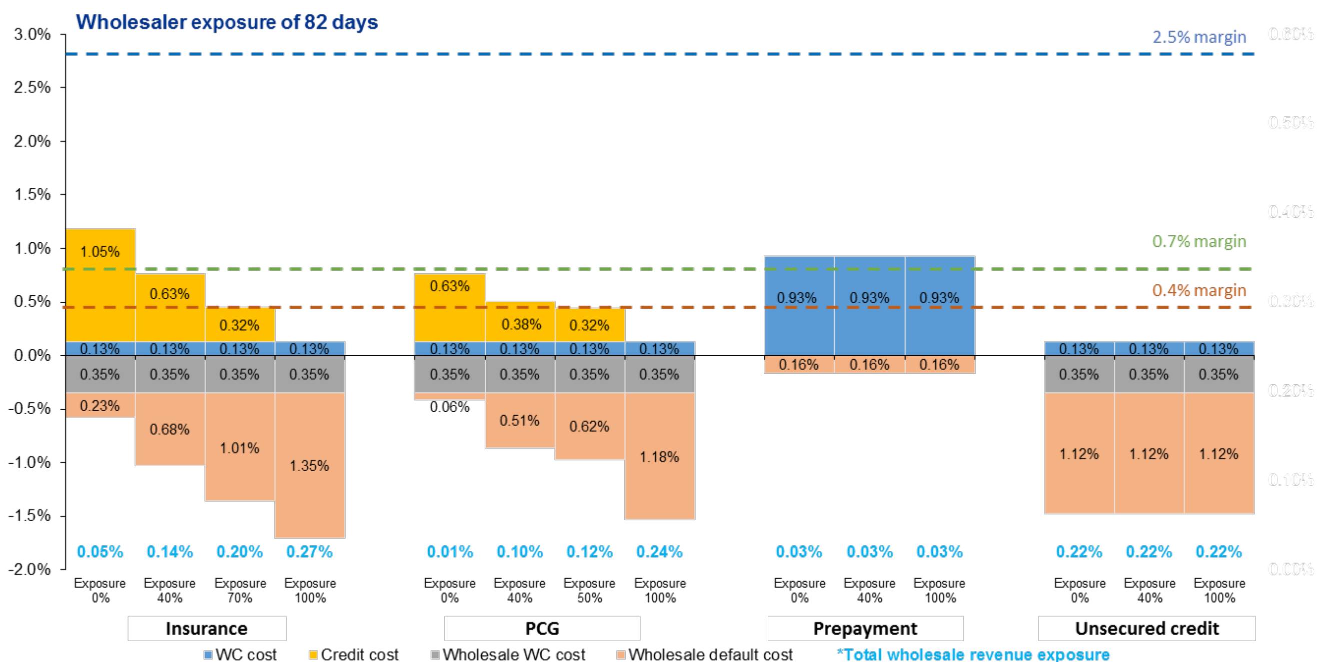
tie up significant amounts of capital and could present a barrier to entry for that market.

3. Minor retailer defaults, of the sort experienced in the Scottish market, are more likely and not likely to have a material impact on wholesalers but an extreme and significant retailer default could have a material impact on wholesalers unless some credit collateral was provided by retailers.

4. Examining precedents in other sectors and considering what the efficient allocation of risk might be we are mindful of the DCUSA arrangements in the UK Energy sector which effectively allocate 60% of the risk of retailer default with the retailer.

Based on this analysis we propose that retailers should be required to provide 50 days of collateral cover. We believe that this approach would a) represent an efficient sharing of risk, b) promote competition in the retail market for the benefit of customers and reduce entry barriers to that market, c) avoid tying up capital in that market unnecessarily which would be inefficient and d) cover the majority of the risk associated with a retailer default and encourage credit worthy entrants into the market with any residual risk being immaterial to a wholesaler under any of the various credit options.

Figure 6: Potential wholesale impacts from a major retail default



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. At present, we do not consider that such a mechanism is required. The analysis suggests that this level of risk would not have a material impact on wholesalers, even in the event of a material default and companies already have a number of re-opener mechanisms within the existing framework available to them that they could seek to use were such an extreme event to occur.

However, we discuss the potential case and form that such a mechanism could take further in chapter 3 and welcome views from stakeholders about whether such a mechanism would be appropriate particularly given the residual risk being placed on wholesalers.

Q4 Does our proposed approach of requiring retailers to provide wholesalers with 50 days of collateral through the credit arrangements represent an efficient allocation of risk? Please provide evidence to support your answer

2.5 Developing the detailed terms under each of the proposed credit options

Having considered the appropriate balance of risk, below we summarise each of our detailed proposals for the six credit options, and also propose a seventh option that we consider should be added to the codes that would allow alternative credit arrangements to be taken forward where both parties agree. Each of the detailed terms of the credit arrangements are set out in appendix 2.

The six proposed credit options

Below we summarise the six credit options that we propose to take forward to the Interim Code Panel for their potential inclusion in the codes. These proposed options have been selected following the work to date and are based on a series of stakeholder engagement, including an industry-wide consultation, workshops and dialogue with market participants and other stakeholders including banks and rating agencies that have experience providing credit support across a range of sectors and companies. In addition, existing precedents in relevant markets have also been taken into account; these are set out in appendix 3.

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 propose 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.

The menu of proposed credit options is listed below:

- **Cash:** 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. The retailer will be responsible for depositing funds equal to 50 days of supply into the account before any service is provided by the wholesaler. In a case of default, the wholesaler will be able to withdraw from the account and potentially recover 100% of the funds required.

- **Letter of credit:** 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. The retailer will obtain an irrevocable standby letter of credit with a collateral coverage equal to 50 days of supply from a bank which holds an investment-grade credit rating. Banks in turn may require other forms of security, such as a parent company guarantee.

- **Third party guarantee:** This option involves a guarantee of payment or performance of obligations of the retailer by a parent company or third party guarantor. Under this option, the retailer is required to obtain a guarantee from a guarantor before any service is provided by the wholesaler. The guarantee must cover the cost to the wholesaler of any recovery of unpaid wholesale charges equal to 50 days of supply. A credit threshold is typically applied to the provider of the guarantee (the parent). As a result, guarantees are considered less secure than cash, as they carry the associated credit risk of the guarantor.

- **Insurance:** 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. Where a retailer defaults and a claim against the insurance is considered valid, the wholesaler will recover losses through an insurer, who will pay reparation that will not exceed the surety bond amount, equal to 50 days of supply.

- **Unsecured credit:** 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. Retailers are allocated a specific percentage allowance of unsecured credit based on their credit worthiness 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 assessment or through the demonstration of good payment history with the wholesaler.

- **Pre-payment:** A pre-payment 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.

Specific details of the individual features associated with each of the credit options are set out in appendix 2, including key assumptions that underpin the financial analysis presented in the previous section. We recommend respondents review this in detail when commenting on the proposals in this consultation.

These more detailed descriptions of each of the credit arrangements build on the initial list developed at the workshop in June 2015 and include specific characteristics of each of the options (e.g. coverage, timings etc.). Below we set out some specific questions on the proposed credit arrangements but we welcome any views from stakeholders on any aspects of these proposals.

Q5 Do you support the inclusion of the six credit options set out in chapter 2?

Q6 Are there any changes to the proposed credit options that you consider are required and if so why? Is any further detail required in the credit arrangements for inclusion in the codes?

Q7 Is investment grade status the right threshold for assessing retailers in order for them to obtain unsecured credit? If not is there a better alternative that we should consider?

Q8 What is the minimum creditworthiness that should be required from a third party guarantor?

A potential seventh credit option

Feedback during the development of the credit arrangements raised concerns that some participants may not be able to meet the criteria set out to qualify for obtaining one or more of the proposed six credit options. In particular, there were concerns that some retailers may have difficulty obtaining either a credit rating or a guarantee from a parent company or third party.

This could mean retailers might be restricted to the least attractive and most costly options, which might deter entry or otherwise negatively impact on market development. Similarly, there was a concern that, whilst a wide range of options is provided and whilst it was accepted that wholesalers may have an incentive and opportunity to disrupt entry where negotiation was required nevertheless were both parties able to agree to an alternative arrangement for credit this should be permitted.

As a result we are proposing to introduce an additional seventh option to the proposed set of credit terms that would provide more flexibility for participants to tailor credit arrangements to their specific needs and preferences, without affecting the other six regulated options. Any such option would need to be by mutual agreement of the parties – otherwise, one of the six regulated options would have to be selected. Retailers would be free to choose any of the seven options, and wholesalers could only refuse the seventh option.

The potential seventh option could take the form of a bilateral agreement, where terms would be negotiated by the parties. We consulted on a similar set of proposals for 'non-standard' terms in 2013 and one respondent to that consultation expressed concerns that allowing wholesalers to offer non-standard terms creates the potential risk that they could offer overly generous terms to their own retailers and so inhibit competition. To limit this risk we propose that any non-standard credit terms agreed between any two parties, including between a wholesaler and its own retailer, must be published and made available to any other party with a similar level of creditworthiness.

We welcome stakeholder views on this proposal.

Q9 Should Ofwat introduce a seventh credit option? What are the risks and benefits of such an option?

3. A wholesale risk sharing mechanism

3.1 What is a 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 discuss precedents for such mechanisms in appendix 3). 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 PR14 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 are considering for the new retail market 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 in the credit arrangements.

3.2 Should we introduce a wholesale risk sharing mechanism?

In other sectors where similar mechanisms exist there appear to be a number of reasons why they have been used but we consider that there are likely to be three key reasons why such an arrangement might be appropriate in the water sector for the business retail market.

1. **To ensure the more effective operation of the relevant market resulting in better outcomes for customers** – introducing the mechanism could reduce the working capital requirements on retailers, encouraging more entry into the retail market and higher levels of rivalry and choice for customers.

2. **To ensure appropriate risk mitigants exist for regulated companies to better ensure the delivery of essential services** – where the risk of retailer default may be material to the financeability of the company and the delivery of the essential

service a wholesale risk sharing mechanism may better protect the delivery of these services for customers.

3. **To better reflect the uncertainty of retailer default in conjunction with the credit arrangements** – as the analysis in chapter 2 makes clear, the risks to the wholesaler from a retailer default are only material in the event of default by one or more retailers where they serve a large proportion of that wholesalers non-household customer base. Defaults of this scale are likely to be rare, albeit that the experience of other sectors suggests that these defaults may occur and in a competitive environment we should expect retailers to fail. Using a risk sharing mechanism would provide a recourse in these more extreme circumstances – a form of backstop protection.

Correspondingly, there are a number of arguments against introducing such a wholesale risk sharing mechanism.

1. **It may be seen as unnecessary in light of other existing risk sharing mechanisms –** wholesalers can already seek recourse to the regulator to re-open or true-up price limits in certain circumstances, for example through Substantial Effect Claims. These mechanisms were not specifically designed for this purpose but may be seen as sufficient to address the concerns.

2. **It may allocate risks to the wrong place –** generally risks should be allocated to those who are best placed to manage them. The risk of retailer default can, generally speaking, best be managed by retailers. A counterparty in a contract would, under circumstances where neither party had significant market power, seek to manage their exposure to bad debts resulting from the default of the counterparty by seeking collateral and taking whatever other steps they could to manage the risk. By allocating some of the risk to customers, there may be a chilling effect on these incentives, resulting in less efficient management action by retailers and wholesalers.

There are some issues that need to be considered if such mechanisms were to be used to address risks and costs related to retail and wholesale credit arrangements. There are a number of existing mechanisms in appointed company licences through which appointed companies (or Ofwat) can seek to re-open price limits. The main mechanisms are IDoKs and the substantial Effects Clause.

Figure 5: Risk sharing arrangements for appointed companies

Interim Determinations

All companies can ask us to reset their price limits between five-yearly price reviews. They can ask for this if specific changes lead to a significant reduction in their revenue or increase in their costs. This is known as an **interim determination (IDoK).**

When we receive an application from a company we look at this against the list of criteria set out in its licence.

- **Materiality** – we test the application against a set level. If the changes in costs, receipts or revenues are at least equal to 10% of the company's turnover we say the application is material. A company can add together a number of specific changes.
- **Triviality** – if the value of a change relating to one issue is less than two per cent of the annual turnover for the relevant service for individual items (or 2% of combined turnover where items span water and wastewater) then we would not include this in the materiality test.

If the company has an application that passes the test of materiality, we will adjust its price limits.

The specific changes that can lead to an IDoK are called relevant changes of circumstance and notified items. Relevant changes of circumstances are described in companies' Licence Condition B. Notified items are set by us at a price review.

IDoK applications must be submitted at least 6 months in advance of the charging year. IDoK's normally cover the remaining time until the next price review and the new price limits set apply from the start of the next charging year in April.

Substantial Effects Clause

Appointed companies can also ask us to change their price limits if an unforeseen circumstance substantially increases any of their costs or revenue. This is known as a substantial effect determination.

When we receive an application from a company we apply a two stage test.

First, we consider whether the application is sufficiently material (defined as equal to at least 20% of company turnover) and whether prudent action by the company would have meant the impact on revenue or costs could have been avoided.

- Second, having established that the materiality hurdle is cleared, we assess whether an adjustment to price limits is necessary. In making this assessment, we consider our duties under the Water Industry Act 1991.

Companies can apply for a substantial effect determination at any time. Like IDoK's, they normally cover the remaining time until the next price review and the new price limits set apply from the start of the next charging year in April.

3.3 How could such a mechanism work alongside the other credit arrangements?

The case for a wholesale risk sharing mechanism may be marginal and to the extent that such a mechanism were introduced, we consider that it should only ever cover a proportion of the risk of retailer default. A back-stop protection for more extreme examples of retailer default would appear to be consistent with other sectors.

As such it would always need to work in conjunction with the other credit arrangements and would be used to replace, in part, the collateral a retailer would be required to provide if it was covering 100% of the risk of default, thus reducing the costs to the retailer while maintaining protections for the wholesaler.

Generally we consider that were such a mechanism to be introduced it should be used alongside the proposed credit arrangements set out in chapter 2 and appendix 2, rather than instead of some of those arrangements.

3.4 How could such a mechanism be designed?

Were a risk sharing mechanism to be introduced, our proposed approach is set out in appendix 4, but in summary we would propose that:

- risk sharing would be triggered only in the event of a complete retailer default;
- a threshold of 1% of total wholesale turnover would apply;
- tests around control, comparability with other companies, materiality and customer interest would apply consistent with the approach that we took at PR14;

- the evidence required to support a claim would be similar to that required for the PR14 risk-based review;
- a cap of 40% on the total costs that could be recovered would apply;
- only the non-household customers of affected wholesalers would bear the costs;
- wholesalers would recover costs at the next price review through a true-up;
- wholesalers would need to lodge a claim with us in writing;
- wholesalers would first have to seek recovery under contractual obligations with the retailer, then against the credit collateral;
- the wholesaler would be required to notify us of a default within 30 days;
- once all civil processes were complete and the wholesaler had received any payments due under the credit support options, the wholesaler would have 30 days to provide us with evidence to support any remaining claim and we would make a decision within 90 days;
- an initial mechanism would be in place from April 2017 but not result in any cost recovery until AMP7; and
- this initial mechanism could then be developed into a more refined mechanism as part of the methodology for PR19 and could take effect from AMP7 if that was considered the most appropriate approach.

We are not proposing any changes to the conditions of water company appointments ("licences") to implement any wholesale risk sharing mechanism. If this were to be taken forward, then we consider that it could sensibly be implemented as a true-up mechanism in PR19.

Q10 Do you consider that a wholesale risk sharing mechanism should be introduced for the business retail market? Why do you consider this and what evidence can you provide to support this position?

Q11 What could be the potential impact of wholesale risk sharing on new entrants and market competitiveness?

Q12 If a wholesale risk sharing mechanism were introduced, how should it interact with the proposed credit options?

Q13 We welcome your views on the specific features of a risk sharing mechanism (should one be introduced) covering: triggers, materiality, justification and evidence, coverage, exclusions and caps, burden of recovery, timings, process, administration and order or recovery and practicality and costs.

4. Next steps

We welcome stakeholder views to this consultation document by 7 July 2016.

We will carefully consider respondents views before setting out our proposed approach in a decision document in late July. That decision document will set out:

- The proposed credit arrangements for the codes that we intend to put before the Interim Code Panel for their consideration and ratification; and
- Whether the arrangements will include a wholesale risk sharing mechanism and if so what form that should take.

Following the publication of that decision document the Interim Code Panel will be free to consider the proposals and include the final credit arrangements in the codes ahead of the shadow market opening in October.

Ofwat will also take forward the development of any potential wholesale risk sharing mechanism as part of its methodology consultation on the 2019 Price Review in June next year and the statement in December. Were such a mechanism to be introduced, that methodology consultation would set out how such a mechanism would operate and commit to both a true-up adjustment for any relevant retailer default between April 2017-20 and any such adjustment in the 2015-20 period.

Q14 Do stakeholders have any concerns with our proposed next steps and timescales for resolving the outstanding credit arrangements?

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

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Printed on 75% minimum de-inked post-consumer waste paper.
June 2016

ISBN 978-1-910739-69-3

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