Appendix 2: Overview of different credit options and the proposed approach

This appendix describes our proposed approach for each of the six credit options that, following consultation, we intend to take to the Interim Code Panel for their consideration prior to inclusion in the codes (in addition to the proposed seventh option as referred to in the main consultation document).

Cash

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.

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.
- The letter of credit must be for a minimum of one year.
- The adequacy of the collateral provided by the letter of credited is reviewed at least annually by the wholesaler.
- 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

- 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 (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 adequacy of the collateral provided by the guarantee is reviewed at least annually by the wholesaler.
- 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.

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-	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

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%).