Appendix 3: Lessons from other sectors

There is a wide range of arrangements in place in other sectors to share risk and reward among different market participants. Below we highlight what we consider to be some of the closest precedents where these mechanisms exist.

UK energy sector

In UK electricity and gas distribution a wholesale risk sharing mechanism is used to recover bad debt costs from the default of a retailer or supply business. 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. In practice, based on past cases where default has occurred, the level of coverage required has been lower. The level of costs that need to be recovered will primarily depend on how much the credit and other protection arrangements are able to cover.

Ofgem maintains a level of control and discretion over the execution of the mechanism and it provides an extensive list of information that it requires from a defaulting retailer. Ofgem has been able to act immediately after receiving official notice of retailer default (within hours of revoking a supply licence).

A series of retailers defaulting in the UK during the early 2000s was a driver behind the formation of the current credit support arrangements in the UK energy sector. There were 11 major defaults from 2000-2004, and Ofgem applied similar provisions to those companies defaulting. There was recognition that distributors required some backstop protection in case the credit support arrangements in place were insufficient (given that distributors cannot choose their counterparty and cannot vary their charges to make up for any losses arising from supplier default). A reduction in the burden of credit support requirements on suppliers (particularly smaller suppliers) was also a factor. The average impact of defaults in the energy sector from 2000-2008 equates to 0.02% of wholesale revenues.

Some of the key considerations around use of an approach similar to DCUSA in relation to credit terms might include:

- The energy supply market and the DCUSA covers both household and non-household customers so the scale of the market and therefore the overall risk of default is much greater;
- The energy market is bi-lateral and many of the examples of retailer default are organisations that had both generation and supply operations- the risks faced by

suppliers are different and the opportunities to manage those risks are therefore different;
- The mechanism is designed to be a backstop in case credit support is inadequate, it is only triggered in extreme circumstances of default;
- The initial credit support requirements were revised to be less onerous on retailers; and
- The regulator has a degree of discretion under the mechanism.

Figure A3.1: Examples of major default in the UK Energy sector

Enron

At the time of default in 2001, Enron supplied gas in the UK to 12,000 non-household customers and electricity to 149,000 non-household customers. The total amount owed to distribution companies was £16m.

Enron's credit cover was provided through credit ratings and parent company guarantees. The credit cover proved to be insufficient. After recovering all expected payments, around £4-8m of bad debt was shared amongst consumers using the risk-sharing arrangements.

Independent Energy

Independent Energy was a new entrant in the UK, with about 240,000 customers. It defaulted in 2000 as a result of £19m of unpaid charges.

The security cover consisted of a letter of credit for transportation and balancing electricity, however this was not sufficient to cover the entire amount due.

Ofgem discovered that some distribution companies had failed to collect debts many months overdue. Independent's security cover was not enough to cover these amounts.

Over 80% of charges were recovered through the security cover, while the remainder was shared amongst all consumers.

Australian energy sector

The mechanism used in the energy sector in Australia specifies a list of triggering events, including retailer insolvency. A distributor has 90 business days to notify the regulator of supplier default.

There is a materiality threshold of 1% of the distributor's annual revenue under which the distributor incurs costs. No cap or coverage rate is in place. There are no tests to determine whether recovery is allowed; instead, the Australian Energy Regulator (AER) must determine the approved amount that can be recovered, which may be nil.

Disallowed costs are set out, including:

- amounts recovered or recoverable from the retailer under relevant existing credit support;
- amounts recovered from winding-up of retailer; and
- costs recoverable under Retailer of Last Resort scheme (i.e. relating to appointment of a new retailer, not relating to debts owed by a defaulting retailer).

This disallowed costs information is used by AER to determine the amount of costs that can be recovered and they must determine if the event is eligible within 40 business days.

The wholesale risk sharing burden is covered by all network user companies, which ultimately transfer the cost to all consumers.

The rationale for use of a risk sharing mechanism in Australian energy includes recognition that distributors require protection from supplier default, but the regulator should play a role in determining what costs should be recoverable (rather than allowing automatic recovery).

Some of the key considerations around use of an approach similar to the Australian energy sector in relation to credit terms might include:

- the materiality threshold is set quite low, but the regulator can exercise judgement in applying the mechanism;
- no cap is in place, so claims could potentially be substantial if an exceptional default event occurs (although there is a set of disallowed costs that could help limit the size of a claim);
- the mechanism is designed to share the costs across all network user companies, not just the distributors affected by a supplier default; and
- the regulator has a significant degree of discretion under the mechanism.

Arrangements in the Scottish Water market

The Scottish water market has been open to non-household competition since 2008. Despite some key differences, it is arguably one of the most comparable markets to

England and Wales, and it is therefore helpful to understand what the arrangements are in Scotland.

No risk sharing mechanism is in place in Scotland. Instead, there are regulated credit support options available to licensed providers for the payment of wholesale charges to Scottish Water (the only wholesaler in Scotland), including pre-payment, escrow account and guarantee.

Pre-payment is required 10 business days before the start of the month.

An **escrow account** is required if the licensed provider chooses to pre-pay wholesale charges and does not have a demonstrable business track record. In addition:

- An account is to be opened and operated by the wholesaler.
- The balance must be maintained at the greater of £50,000 or the monthly amount due.

Where a **guarantee** is chosen by the retailer, it must cover the retailer's payment obligations under the market framework arrangements and the cost to the wholesaler of any recovery of unpaid wholesale charges. In addition:

- Any guarantor is required to have a minimum investment grade credit rating.
- An appropriate rating from any of the three ratings agencies will be suitable.

There has been one default 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).

Key observations from the Scottish market include the absence of a wholesale risk sharing mechanism, which may call into question the need for such an arrangement for the non-household market in England and Wales. The rationale for the arrangements in Scotland included a requirement to demonstrate financial viability, which the regulator initially implemented by requiring pre-payment from all retailers.

Guarantees were later introduced as a result of the increasing maturity of the competitive market and the changes that took place within credit markets. The objective was to avoid prepayment becoming a barrier to entry (given the cash flow pressure that could result from prepayment), whilst ensuring that Scottish Water was not placed in a position that is financially less secure or carries additional risk.