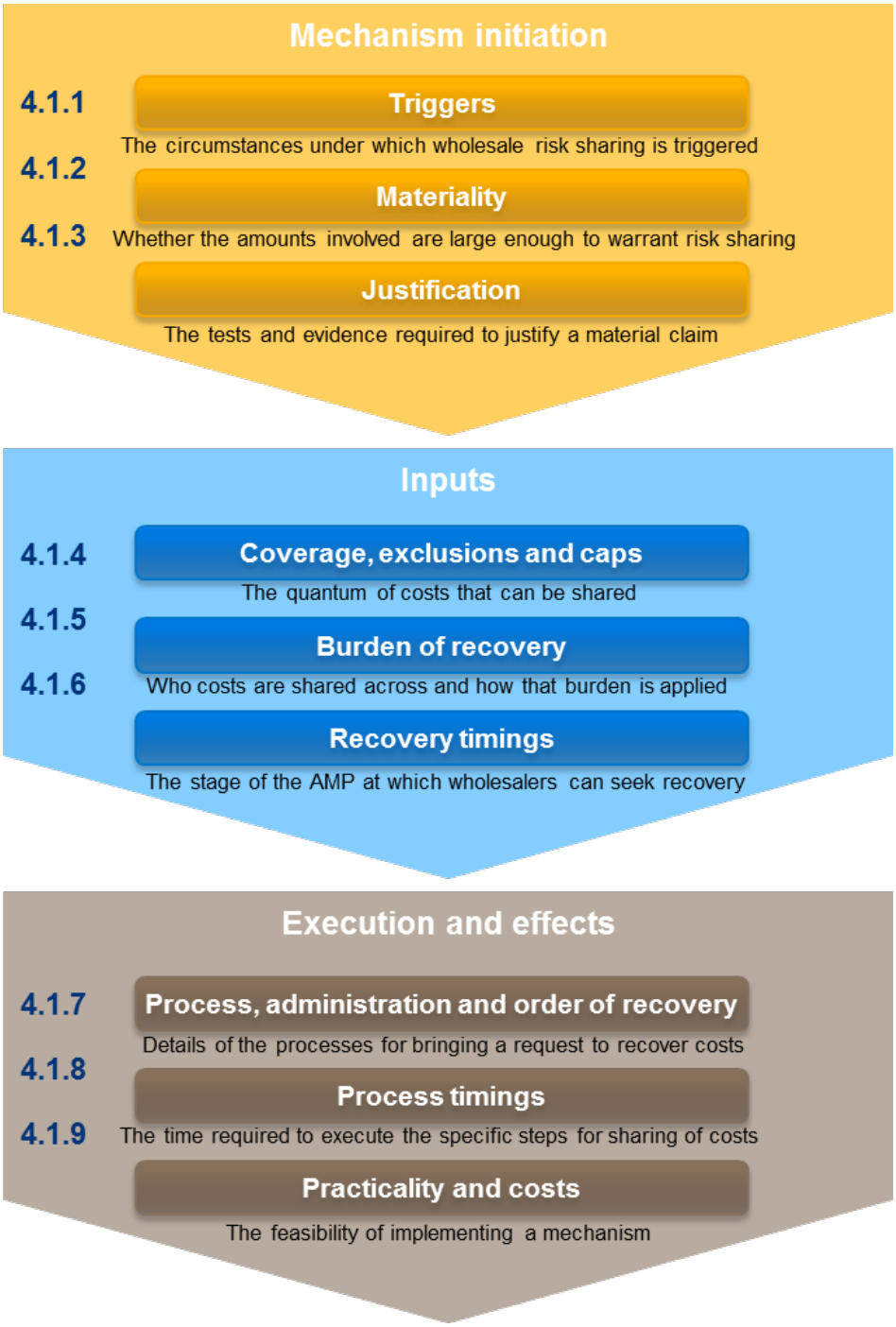
Appendix 4: A wholesale risk sharing mechanism

If a wholesale risk sharing mechanism were to be introduced we would need to define how that mechanism could work in practice. The diagram below sets out the nine key features that we believe would need to be considered.

Figure A4.1: Key features of a wholesale risk sharing mechanism



Triggers

The circumstances under which wholesale risk sharing is triggered need to be defined, including any criteria that apply if the regulator is to have any discretion.

The mechanism should define what a retailer default is. The current Business Terms of the MAC define certain circumstances for default and it would be possible to use the same terms for the mechanism to limit its scope to the relevant circumstances.

Triggers can then be set on a spectrum, ranging from a fully automatic mechanism to one where substantial discretion is provided to the regulator over the use of the mechanism. If the regulator has discretion, there may be less certainty for the wholesaler over the recovery of costs in the event of retailer default. However, discretion can help to ensure that only efficiently incurred costs are recovered and regulatory discretion is common in the precedent examples from other sectors.

We generally consider that were such a mechanism to be introduced, some regulatory discretion would be appropriate. Such discretion can be exercised through the application of tests that are set out in advance, which improves transparency and certainty.

- The current IDoK and SEC mechanisms set out various criteria/tests for the regulator to apply and they must be evaluated on a case-by-case basis.
- In UK energy distribution there is some scope for regulatory intervention – Ofgem can exercise judgement around the implementation of risk sharing mechanisms (e.g. DCUSA).
- There is very open scope for regulatory intervention in the Australian energy sector. The Australian Energy Regulator determines the approved amount that can be recovered with reference to a pre-determined list of non-allowed costs but without reference to any tests such as prudent management action or materiality.

We propose that risk sharing would be triggered only in the event of a complete retailer default (i.e. it would not apply where a retailer was technically in default through late payment but default proceedings had not actually been brought to completion), and that, as in UK energy, the regulator would exercise a degree of discretion by specifying and applying appropriate tests to satisfy itself that risk sharing should be applied.

Materiality

Materiality refers to whether the amounts involved in a claim are large enough to warrant applying risk sharing. There are two potential approaches to materiality:

- the regulator can be left to exercise discretion over whether the amount claimed is material, which it would determine after a claim was brought; or
- materiality can be determined using thresholds set out in advance.

Other existing regulatory mechanisms applied in water in England and Wales make use of materiality thresholds:

- For PR14, both materiality and wholesale cost claims, a threshold of 0.5% of totex over the AMP was used. This equates to around 1.25% of wholesale revenue for a year.
- For risk and reward sharing, 1% of the turnover for the relevant service was used as the PR14 threshold.
- To bring an IDoK claim, two thresholds must be met: 2% of annual turnover for the relevant service for individual items (or 2% of combined turnover where items span water and wastewater), and a minimum 10% of company turnover for the total claim. In addition to these thresholds, items must be either a Notified Item (NI) or a Relevant Change of Circumstance (RCC).
- The SEC threshold is 20% of company turnover, which is higher than for IDoK, but an SEC claim can be brought for any event that has a substantial effect on the company, and is therefore not limited to a NI or RCC.

And in other sectors:

- The Australian energy sector has a materiality threshold of 1%.
- Some mechanisms in other markets have no thresholds.

Having no threshold may create an administrative burden if claims are marginal, especially where a single retailer defaults owing multiple wholesalers very small amounts. Even if the total owing is substantial when combined, it may not be proportionate to apply risk sharing in this case, and any thresholds set should take this into account.

In order to avoid the administrative costs and burdens of dealing with marginal cases, we propose that risk sharing would be applied only where the quantity of allowable costs was greater than 1% of total wholesale turnover, in line with PR14 risk and reward provisions.

Justification

The justification and evidence that parties (primarily wholesalers) need to produce to support a request to recover costs under risk sharing should be specified. There are two options for this:

- the regulator can exercise discretion over the evidence required and use judgement to determine whether the claim is justified; or
- tests and evidentiary requirements can be specified in advance.

Tests can be designed to ensure that, even where a claim passes the materiality threshold, it is still justified on relevant grounds. This is in order to protect customers, ensure parties are appropriately incentivised and maintain a level playing field and fairness in the application of regulation.

Excessive evidentiary requirements may create a burden on companies and the regulator. Minimum levels of evidence are likely to be required to justify wholesale risk sharing. The quantity and strength of evidence may need to be higher where the regulator has more discretion.

A range of evidential requirements is in place under various regulatory arrangements in water, from light touch arrangements such as self-certification to heavier arrangements such as independent evidence and external assurance.

- The IDoK and SEC arrangements have specified tests around materiality, prudent action by management, strength of evidence submitted, substantial adverse effect and so on.
- PR14 used tests for risk and reward that covered control, comparability with other companies, materiality and customer interest.

We propose that some tests should apply to any claim for risk sharing and the evidence required to support a claim should be similar to that required for the risk-based review used at PR14, but without any formal hierarchy used to set different levels of evidentiary burden among companies; that is, all wholesalers would need to provide the same level of evidence. The PR14 tests that we propose to use for evaluating a claim for risk sharing (and for which we would require submission of adequate evidence) are control, comparability with other companies, materiality and customer interest.

Coverage, exclusions and caps

The quantum of costs that can be shared, including any caps, may need to be set out. There are various options that could be pursued here, based on other examples:

- A cap could be set out as to the total amount recoverable from the mechanism – the UK energy precedent includes a cap of 40% of the total amount owing to the wholesaler by the defaulting retailer.

- Certain categories of cost could be pre-defined that would not be recoverable through the mechanism could be specified (for example, as used in Australian energy).
- Alternatively, eligible costs could be assessed case-by-case based on evidence presented or no caps could be put in place.

We propose that there be a cap of 40% of the total amount owing to the wholesaler by the defaulting retailer that can be recovered from a risk sharing mechanism, consistent with the UK energy example.

Burden of recovery

Who costs are shared across (e.g. industry-wide or only customers of affected wholesaler/s), and how that burden is applied (e.g. as a flat rate, proportional to customer size or at the discretion of a company) needs to be considered. The burden could fall on all or only some customers. There could be an option to recover costs from affected customers in the first instance (e.g. during the current period) and later share the costs across the whole industry (e.g. through a true-up in the next period).

We propose that only the business customers of affected wholesalers bear the costs, in line with the UK Government Charging Guidance (which states, “It remains an important point of principle that households will not pay for the implementation of the competitive market”).

Recovery timings

The stage of the price review cycle at which wholesalers can seek recovery through wholesale risk sharing needs to be set out (that is, whether there is an automatic re-opener or a later true-up). Options include:

- Wholesaler/s recover costs at the next price review; or
- Wholesaler/s recover all costs in-period.

The contestable market is scheduled to open part-way through the current price review period (from April 2017), so the credit arrangements will only apply for the last three years of this price review period.

An in-period mechanism (which would require a licence change) could provide wholesalers with earlier access to recovery and improve their cashflows and financial situation. Wholesalers could make use of civil recovery under the Wholesale Contract and the credit collateral provided by retailers in the first instance, which

could reduce the requirement for in-period recovery and leave the wholesaler to recover only the balance of costs as a true-up in the next period.

A true-up could be carried out as part of the routine functioning of the next price review, and would allow time for the exact provisions of a risk sharing mechanism to be developed as part of the price review methodology before the next AMP.

We propose that wholesalers would recover costs at the next price review through a true-up (having first sought recovery in the order we propose below).

Process, administration and order of recovery

Details of the processes for bringing and implementing a request to recover costs through a risk sharing mechanism will need to be defined.

Risk sharing could take the form of a new mechanism to be included in appointed companies' licences (similar to an IDoK), or it could be applied as a true-up within the price review methodology. Our view is that it is proportionate to implement any risk sharing as a true-up under the price control, rather than a licence change.

After a wholesaler brings a claim, the steps involved and who carries them out should be described. For example, if the wholesaler must lodge a claim, the regulator will need to receive and evaluate the claim and may need to give the wholesaler time to respond to a draft decision. The regulator may wish to consult on the claim if it is substantial.

The parties relevant to a claim under the mechanism should be set out so that it is clear what role they play and what interdependencies may apply.

- As wholesale risk sharing is a regulatory mechanism, it is assumed Ofwat will play a role, but others may also, for example administrators, liquidators, courts, external advisors, consumer representatives or other stakeholders.

- If the proposed order of precedence is put in place, certain steps to recover under the Wholesale Contract and any retail collateral will need to take place first, which is where external parties are likely to be involved. For example, if a defaulting retailer has posted a third party guarantee or a surety bond, the guarantor or insurance provider will have a relevant part to play.

The order of recovery needs to be specified so that it is clear what forms of protection wholesalers can rely on and what risks and costs customers may bear.

- Wholesalers could be required to first seek civil recovery from a liquidator/administrator, then seek payment under collateral arrangements with retailer and only after these are exhausted apply for sharing of remaining costs.

- This would avoid the risk of wholesalers recovering more than once – for example, if wholesalers were able to recover retailer bad debt under risk sharing first, they could then seek civil recovery against the administrator; while there may be few assets left to distribute, wholesalers might nevertheless be able to recover some amounts twice, which appears to place an inappropriate cost burden on customers.

We propose that wholesalers will need to lodge a claim with us in writing. Before any recovery of costs occur, wholesalers must first seek recovery under contractual obligations with the retailer (i.e. liquidator/administrator), then against the credit cover, only using the risk sharing mechanism as a backstop after those processes have been completed.

Process timings

The time required to execute the specific steps for sharing of costs should be set out. Depending on roles and the other parties involved, the regulator or others may require some months to review and determine claims. Some of these timescales may be out of the control of the regulator. For example, civil recovery is likely to work to a separate timeline which the regulator cannot influence.

We propose that the wholesaler be required to notify us of default by a retailer within 30 days of the default occurring in order for the risk sharing mechanism to be initiated. Once all civil processes relating to the liquidation of the defaulting retailer are complete, and once the wholesaler has received any payments due under the credit support options, the wholesaler will have 30 days to provide us with evidence to support any remaining claim for recovery of costs under the risk sharing mechanism. We propose that we would evaluate the claim and make a decision within 90 days. Implementation will then occur in line with the timings for recovery proposed outlined above.

Practicality and costs

The feasibility of implementing a mechanism within the timeframes required for market opening needs to be considered. Implementing a mechanism requires resources and therefore incurs costs. These need to be taken into account in order to evaluate practicality.

In our view a wholesale risk sharing mechanism could be a proportionate response to ensuring risks and costs are shared appropriately among wholesalers, retailers and customers. However, we do not consider it would be proportionate to introduce a mechanism in the form of an in-period re-opener during the period 2017-2020, as the time, resources and burden on all parties to put this in place during the AMP would be unwarranted.

Instead, we believe it would be proportionate to have an initial mechanism in place that applies from April 2017, but does not result in any actual cost recovery until AMP7. This initial mechanism could, if necessary, then be developed into a more refined mechanism as part of the methodology for PR19 and can take effect as from the start of AMP7.

Summary of our proposed approach

Were a risk sharing mechanism to be introduced, our proposed approach would be as follows:

- 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 as 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 business 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 note that, owing to there being very few eligible customers in Wales, the chance of the mechanism being activated is lower (if we were to implement one). We would propose the same materiality requirements whether a wholesaler were English or Welsh but note that such a mechanism is very unlikely to be needed in Wales under the current legal framework.

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