Ofwat

Ofwat review of credit arrangements in the business retail market

Introduction

In December 2017, we announced an initial review of the credit arrangements in the business retail market. This document sets out our view and next steps on the credit arrangements following receipt of KPMG's final report to us which we are also publishing today.

The aim of the review was to establish whether the current arrangements create undue and unfair barriers to entry. We were particularly concerned to understand how the current arrangements affected smaller new entrants, and whether there were any areas of the current arrangements that could be clarified or improved, to the benefit of the market.

This document is structured as follows:

- We first set out the high level key findings from KPMG's review, along with the proposals put forward by KPMG
- We then discuss our view on these key findings and the proposals
- Finally, we discuss the next steps associated with this work.

Key findings from the review

A number of key findings emerged from KPMG's review that formed the basis of the recommendations included within the final report.

Broadly, the credit framework does not require significant change at this time

The review found that, in principle, requiring collateral is not a barrier to entry in and of itself. The current risk allocation between wholesalers and retailers is considered appropriate and the credit arrangements prevalent in the business retail market in water are similar to those present in other regulated markets.

There are potential level playing field concerns in access to and use of some credit options

KPMG's review found that there may be an un-level playing field where a Parent Company Guarantee (PCG), or some other form of credit, is intra-group between a wholesaler and its retail subsidiary.

In particular, it highlights that retail credit risk is shared as a result of associated retailers ability to internalise the costs of PCGs, which is an advantage not available to other retailers with different structures. The responses to our formal information request revealed that associated retailers of incumbent wholesalers are primarily accessing PCGs, at zero or low cost and these associated retailers are using PCGs in areas previously served by the incumbent. This creates a potential opportunity for associated retailers to price below the efficient costs of a new entrant.

KPMG's review also found that, separately, there could be a risk of an un-level playing field with regards to schedule 3 or 'alternative credit arrangements'. KPMG's report highlights concerns that some wholesalers appear to have agreed alternative credit arrangements with some retailers but have not published them. More substantially, in some instances, concerns have been raised that these alternative credit arrangements were being established in a way that made them so bespoke to the circumstances of a particular retailer that in effect other retailers, who may have similar credit risk, were precluded from obtaining the same or a similar arrangement with that wholesaler, thus increasing the risk of an un-level playing field in relation to credit.

Proposal 1: Ensure greater transparency of PCGs and alternative credit arrangements
The publication of all PCGs and alternative credit arrangements may improve confidence and certainty in the market. KPMG propose that these arrangements could be published centrally and in a standard format by MOSL so that there is full transparency, including over the costs of such arrangements. KPMG recommend that the Codes Panel raise a change to the codes to alter the obligation to publish the agreed alternative arrangements to one where trading parties are required to notify Ofwat and MOSL of the arrangements and also of arrangements where PCGs are used by associated retailers of former incumbents.

There is limited evidence to support significant change specifically for smaller new entrants at this stage, but general improvements can be made which would help them.

One of the key aspects of the review we asked KPMG to reflect on was the extent to which there should be specific interventions in an attempt to promote entry by smaller new entrants. In particular, we wanted to understand whether there is evidence to suggest such an intervention to be necessary in order to enable the development of competition and bring dynamic benefits in the longer term.

KPMG do not consider that specific support targeted at smaller new entrants to be necessary at this stage. KPMG's view was that:

- the bar for introducing such changes should be high given the early stages of the market and the evidence from other regulated markets; and
- this high bar has not been met given available evidence – specifically, the market has recently provided solutions to reduce entry barriers. For example, a number of wholesalers have published bespoke credit arrangements under Schedule 3 of the Wholesale-Retail Code Business Terms that we are aware have been entered into by 16 retailers. In addition, the Codes Panel has also recommended for approval a code modification (ref CPW019) that will allow retailers with trade insurance access to unsecured credit.

KPMG recommends further general improvements to the credit arrangements which will benefit smaller new entrants (see proposal 2 below).

KPMG also highlight in their report that feedback provided to them from retailers suggests that credit costs are creating a tight operating environment where operating and credit costs for smaller new entrants are close to the maximums allowed under the default tariff caps and the impact of the cost of credit is likely to be material. Several retailers commented that the allowed retail costs in the price controls (that make up a significant element of the gross margin) did not appear to provide for various costs that retailers would experience in the market.

Proposal 2: Unsecured credit option to reflect payment history – KPMG propose that the Codes Panel take forward work to amend the unsecured credit arrangements to better reflect the reduced risk of retailers with a strong payment history and consider the inclusion of an unsecured credit allowance based on credit rating agency reports and scores. KPMG also propose that the Codes Panel investigate whether the codes could be amended so that the unsecured credit values available for strong payment histories and otherwise strong financial standing are based on the values taken from these credit scoring reports.
Proposal 3: Gross margins review – KPMG propose that as part of its work to review the appropriate price protection beyond 2020 Ofwat could consider the sufficiency of the gross margins.

There are a number of areas where the arrangements could be clarified for consistency or improved

The new market is still developing and the codes and market arrangements are being tested in a real market environment. KPMG's stakeholder engagement suggested that that the process leading up to the opening of the market was very time pressured and there was an expectation that amendments to the current arrangements were likely to be needed to improve clarity and consistency. Based on the stakeholder engagement carried out by KPMG, several areas were identified where minor changes could be made across the current arrangements to improve the clarity or consistency of the credit arrangements, and the extent to which they work effectively with the rest of the market arrangements.

Credit assessment scores

KPMG's stakeholder engagement suggests that there may be some ambiguity around the use of credit assessment scores. In particular, there is confusion around the role of wholesalers in challenging or accepting those scores when they are provided by retailers, some concern that wholesalers are interfering with this process by credit checking retailers unilaterally and obtaining their own credit scores which can result in a deterioration of the retailers credit score and wholesalers are concerned that retailers may be 'cherry picking' credit scores to maximise their unsecured credit allowance and not appropriately updating them.

Proposal 4: Credit assessment scores - The Codes Panel could develop and consider a change proposal to the codes that makes clear that:

- credit reports should be provided by retailers more regularly than once every 12 months, perhaps every quarter;
- wholesalers must accept the findings of that credit report where it comes from one of the credit referencing agencies listed;
- such credit reports will not generally need to be updated more regularly than every quarter unless there is some significant change that materially affects the retailers' financial standing; and
- where wholesalers wish to obtain their own credit reports on individual retailers they must inform the retailer before doing so, providing that obtaining this credit report does not directly result in a deterioration of a retailers' credit score.

Termination, default and interim supply

The processes for default and termination are set out in the Business Terms of the Wholesale-Retail code and link through to the interim supply code. Trading parties have indicated that aspects of this process are not clear – for example, it is not clear when notices must be served to the retailer, and that the notifications do not follow a linear process. It was also indicated that the default process can represent a somewhat 'nuclear' option, whereby the wholesaler must choose to place the retailer into default rather than some alternative options.

Proposal 5: Termination, default and interim supply - Ofwat, the Codes Panel and market participants could take forward some work to test the default, termination and supplier of last resort arrangements in the codes. Any inconsistency in timings arising from this exercise or suggestions to create a staged default process could then be taken forward through the Codes Panel as potential amendments to the codes.

Credit negotiations for self-supply

Unlike most new entrant retailers, self-supply retailers have an existing base of supply points prior to entering the market. An issue has emerged because once their licence is granted, they were immediately required to post credit for all of their sites and self-suppliers have indicated that negotiating credit arrangements in this timeline was challenging.

Proposal 6: Credit negotiations for self-supply - Self-supply retailers should use the complete application notice published by Ofwat as a point to begin negotiating credit terms with wholesalers ahead of licence granting.

Financial resilience testing

When Ofwat receives an application for a retail licence, it undertakes an assessment of that retailers' financial resilience which focusses on whether the applicant has sufficient financial resources to finance its obligations and whether it has the capacity to raise new funds in the future.

KPMG's review has found that the purpose of Ofwat's financial resilience testing as part of the current application process is unclear. KPMG therefore consider that either the credit arrangements form the basis of the financial resilience requirements of retail entrants and the financial resilience test should be removed entirely, or, where a case can be made that the test serves a different purpose it could be retained and potentially amended. The financial resilience test should ensure that a new entrant retailer can meet the requirements of the credit terms.

Proposal 7: Financial resilience testing - Ofwat could review and consult on the financial resilience test in its licensing process with a view to making it work more effectively with the credit arrangements in the codes.

There may be alternative credit models that could improve the effectiveness of the market and the outcomes it delivers

KPMG recommend further work to consider alternative models to underpin the credit arrangements. One option KPMG highlight in particular is a 'pooled' credit scheme where all retailers are covered by a single financial instrument.

KPMG consider this option as an overall improvement on the current framework and offers the opportunity to deliver overall improvements to all elements of the qualitative assessment framework, including improving competition, wholesaler financeability, consumer protection, proportionality and regulatory burdens.

Proposal 8: Pooled credit models – KPMG propose that the pooled credit option should be explored further by the Codes Panel as this option offers the opportunity to deliver significant benefits.

Our view

We set out below our initial view on the findings and recommendations arising from KPMG's final report.

We are broadly comfortable with the recommendations that KPMG has identified for the Codes Panel to take forward and have had an initial discussion with the Codes Panel at its meeting in May 2018. We have also recently revised our application process for self-supply retailers and as such agree with KPMG's proposal on that issue which is discussed further below.

In terms of priorities for the Codes Panel, we have asked the Panel to focus on:

- Taking forward the transparency aspect of PCG and schedule 3 alternative credit arrangements-related recommendation (discussed further below)
- Recommendations that relate to use of credit scores and unsecured credit allowance for payment history, potentially packaging these changes together given the interdependencies between the two issues
- Taking forward work relating to the timelines for default and termination, following initial testing of interim supply processes by Ofwat and MOSL.

The following sections set out Ofwat's views on KPMGs findings in relation to each area, particularly highlighting some further actions we intend to take to ensure competition works effectively in the interests of customers.

Level playing field

KPMG's review found that many associated retailers received credit from their wholesalers, which is permissible under the current codes. It also found that these retailers were paying a low or zero cost for this credit. Such arrangements raise concerns as to whether the associated retailer is genuinely bearing 60% of credit risk as per the requirements of the Code. We would be concerned if an associated retailer received credit from its wholesaler and yet did not reflect the economic cost of its credit in the pricing of its retail services; effectively acting as if it bore less than 60% of the risk.

We are intending to write to associated retailers to remind them of their obligations under the Competition Act 1998 and seek reassurance that the manner in which these costs have fed through into price offerings for customers has not had a negative impact on competition. We are keen to ensure that the costs of credit are reflective of a genuine market rate and are not being used in a way to erect an unfair barrier to entry.

Even where associated retailers are appropriately reflecting their credit costs in their pricing, there is a risk to competition developing effectively if it prevents efficient entrants from entering or expanding in the market. Most associated retailers use credit options from their wholesaler, such as PCGs, which are relatively inexpensive. In contrast, new entrants (non-associated retailers) are typically unable to access PCGs and instead have tended to access options, such as cash credit, which the KPMG review has found are relatively expensive and form a significant proportion of all retail level costs for new entrant retailers.

It is not clear to us whether KPMG's recommendation of transparency requirements alone is sufficient to deal with concerns about the level playing field. Therefore, in addition to the transparency remedy, we propose to ask the Codes Panel to gather evidence and assess whether the current credit arrangements give all providers an equal opportunity to compete and specifically whether associated retailers are benefitting from unfair advantages as a result of PCGs. This includes considering whether ex-ante changes to the use of PCGs are appropriate, and to assess the pros and cons of PCG reform in general, including the impact on customers.

We recognise that there are significant linkages between the work we are proposing to ask Codes Panel to do and other work we are conducting, specifically the review of the Retail Exit Code, which will look at the level of margins available, which are influenced by credit costs. We therefore anticipate liaise closely with the Codes Panel in looking at these issues.

Targeted intervention for new entrants

We are reassured by the market based solutions which appear to be providing benefit to a number of retailers, including smaller new entrants. We agree that specific intervention is not warranted at this time, based on the evidence provided.

However, we intend to keep a watching brief on market developments and would be prepared to reconsider our position on these issues should existing arrangements be withdrawn or, if compelling evidence emerged that suggested such intervention was warranted.

We are comfortable with the other recommendation KPMG make related to reviewing the unsecured credit allowance and note that a forthcoming insurance code modification may, if approved, also reduce entry barriers for smaller new entrants.

Changes to clarify or improve the arrangements

We agree with the recommendation relating to testing the default, termination and interim supply timelines and processes. We are mindful of the need to carefully balance the timelines associated with these processes and maintaining the 60:40 risk sharing allocation, while at the same time ensuring that the right information is provided to the market at the right time.

We are already working closely with MOSL to prepare for an interim supply event via a simulation that is planned for mid-July 2018. We propose that the Panel considers options for working through the processes and timelines following Ofwat and MOSL's initial testing of the interim supply processes. Following this testing, we intend to engage with trading parties further with a view to involving them in scenario testing.

We have recently revised our application process for self-supply retailers and as a result do not envisage making further changes at this time. However, as part of the established process, we publish a formal Notice that confirms a complete application having been received. We agree that this is a reasonable point at which self-suppliers could begin negotiating credit terms with wholesalers ahead of licence granting.

Our licensing regime seeks to maximise the opportunity for new suppliers to enter the market, while ensuring that the interests of customers are protected. We will keep the application process and our requirements, including on financial stability, under review as the market develops to ensure that it remains appropriate.

Pooled credit option

A move to a pooled credit model would represent a material change to the credit arrangements at a very early stage in the development of the market. It is not clear whether such a change would be proportionate, given that KPMG has not identified a significant need for changing the current credit arrangements framework at this stage. However, we understand one market participant is looking to develop such a model and we think the Codes Panel is well placed to consider it in the first instance.

If a proposal is developed and recommended by industry and the Codes Panel then we would consider it in line with our obligations under the Market Arrangements Code.

Next steps

In light of KPMG's findings and our views above, we intend to move forward with the following areas in relation to credit arrangements:

1. Given the significance of the risk highlighted by KPMG, we think it necessary for the Codes Panel to undertake an evidence gathering exercise and assessment of the use of PCGs in the market appropriately linking with Ofwat's Retail Exit Code review. We have also requested the Codes Panel to take forward the work proposed by KPMG in relation to the transparency of PCGs and schedule 3 alternative credit arrangements.

   Linked to this, as set out above, we will be writing associated retailers to remind them of their obligations under the Competition Act 1998 and seek reassurance that there has not been a negative impact on competition.

2. Whilst we are reassured by the market based solutions which appear to be providing benefit to a number of retailers, including smaller new entrants, we will actively keep a watching brief on market developments here and will be particularly interested should the market based solutions be withdrawn.

3. We have also had early discussions with the Codes Panel secretariat around the recommendations on changes to the Codes related to payment history and credit the use of credit scores. We think that these two recommendations can be packaged together and taken forward by the Codes Panel (or a sub-group of the Panel) with specific proposals developed by the end of the year.

4. We will be issuing our decision on CPW019, a code modification that seeks to allow retailers with trade insurance access to unsecured credit, before the end of July 2018.

5. We will be issuing our detailed consultation as part of our review of the Retail Exit Code in the autumn and will be issuing a decision statement following that consultation and consideration of responses.

6. We will be carrying out a test of the interim supply process with MOSL in mid-July 2018. Subsequent to this, we will engage with the Codes Panel to conduct an assessment of the processes and timelines, including the issues highlighted by the report and any issues arising from the test.

7. We will keep the application process under review as appropriate so as to ensure that it remains fit-for-purpose and relevant given market and other developments.