OFWAT

Review of credit arrangements for the non-household retail market

KPMG LLP
June 2018

Contents

Important notice

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The scope of our work agreed with Ofwat, information sources, and scope and information limitations are set out in the report. We have made use of both company information (which remains the responsibility of management) and publicly available information. While we have satisfied ourselves, so far as possible that the information presented in this Report is consistent with our information sources we have not sought to establish the reliability of information sources by reference to other evidence. We have relied upon and assumed, without independent verification, the accuracy and completeness of information available from public sources. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future.

Executive Summary

This study was commissioned by Ofwat, the economic regulator of water and wastewater services in England and Wales, in order to review the effectiveness of the credit arrangements for the non-household (NHH) retail market which opened in April 2017.

At the time of writing, the market had been operating for 12 months, during that time a number of concerns were raised with Ofwat by wholesalers and retailers about the credit arrangements. They therefore wanted to understand how the credit arrangements were working in practice and what issues trading parties were experiencing. The approach to the study has involved the following sources of evidence:

- A desktop review of existing market information, current and previous code changes relating to the credit arrangements and a comparative review of credit arrangements in other sectors.
- A series of semi-structured interviews with 11 market participants from the NHH retail market in England and Wales including a mixture of wholesalers, different retailers and self-supply entrants.
- An information request to all retailers to examine the cost of the different credit options that they are using.
- A workshop open to all stakeholders where the emerging findings of the work were discussed and debated.

The assessment of the research questions and the findings from the study are limited to the above sources of evidence. The study has not undertaken a formal assessment of the overall gross margins in the retail market or indeed the pricing approaches of different retailers or for different retailer groups.

Each of the research questions is assessed against a clear but generally qualitative assessment framework based on Ofwat's statutory duties. In particular, the assessment framework considers the potential impacts on consumer protection, levels of effective competition and rivalry in the market, the financeability of efficient wholesalers and the proportionality of the arrangements. The evidence sources highlighted above have been considered in addressing each research question but not all evidence sources are relevant to each of the questions considered.

The study provides a review of the credit arrangements and was undertaken between January and April 2018 but predominantly in February and March 2018. It is not a detailed market study but uses some available market data in the consideration of the research questions.

1.1 Is there a level playing field in relation to credit arrangements?

All new entrants joining the market must negotiate their credit and collateral arrangements with each of the 23 wholesalers if they want to switch customers in their areas. The requirement to post credit was a common arrangement across all the regulated markets that were examined. Counterparties will typically want some collateral in order to take on the risk of a supplier's default in the event of monies being owed. Overall the desktop review suggest that the credit requirements in the retail market codes are similar to those offered in other regulated markets, with a similar mix of credit options and cover. However, the current market arrangements include a larger proportion of unsecured credit cover than some other markets (see Figure 7).

Within the current market structure, an analysis of the information request evidence shows that the associated retailers of former incumbents are relying on Parent Company Guarantees (PCGs), particularly in those wholesale areas where the majority of their customers are located or where their customers were previously served by the incumbent monopoly provider (see Figure 5 and Figure 6)

One of the more significant concerns raised by market participants during the interviews was around the use of these PCGs by former incumbents or initial in area retailers and the extent to which there was a level playing field in the use of credit options. A PCG constitutes a contingent liability on the parent company. The cost of PCG will not appear in the financial statements of the retail subsidiary if the parent company does not charge the retail subsidiary for the PCG. Nonetheless, there remains a cost implication at the group level for extending the PCG where the retail subsidiary subsequently provides guarantees on to external parties. This in theory would affect the overall group credit position and any credit rating held, and would reduce the borrowing capacity of the group. However, in instances where the PCG, or indeed some other form of credit, is intra-group between a wholesaler and its retail subsidiary (i.e. retail credit risk is shared between the wholesaler and the retail subsidiary) the result is that retailers who are associated with wholesalers in the same group may confer a benefit in comparison to other retailers as a result of their ability to internalise the costs associated with different credit options, including PCGs. This could create an opportunity for associated incumbent retailers to price below the efficient costs of a new entrant as a result of lower credit costs.

Based on the evidence it does appear that there is a potential opportunity for the retail prices offered by associated former incumbent retailers to be non-cost reflective. This reflects the opportunities created by intra-group credit arrangements to gain access to credit at more favourable terms. However, there is no information as to whether they have taken advantage of this lower cost of credit in their commercial offers to end-customers and the detailed arms-length arrangements that different retailers have put in place have not been examined.

1.2 Do the credit arrangements represent a material barrier to entry or expansion for smaller entrants?

Whether a new entrant can join the market and compete for customers against other suppliers we assume is largely a function of the quality of service they offer and the costs they incur in serving new customers, including the cost of credit. In the NHH retail market the success of any new entrant may therefore depend on the service they offer and the extent to which they can serve customers at a lower cost than their competitors to provide lower prices. In the regulated NHH retail market back-stop 'default tariffs' continue to exist and these price controls may also create a maximum cap for retailers.

Consultees that were interviewed indicated that there are significant scale economies in providing services to customers in the NHH retail market, i.e. that the marginal cost of providing services to additional customers declines as the number of customers served increases. This is confirmed by the faster rate of consolidation in the water retail market compared to the energy supply market (see Figure 11).

In this environment entry for smaller retailers who have a strategy for organic growth through customer switching, rather than for example growth through acquisition, may be more challenging because they may lack the scale economies of more established players. Indeed there are only three such small new entrant players actively switching customers in the market[1]. This may create a market environment that is more concentrated with a smaller number of much larger players and fewer new entrants. In a market with these characteristics customers may still benefit from lower prices and improved service, for example, from competition amongst larger players with those scale economies.

It is not possible to examine the materiality of the impact of the credit arrangements. Consultation feedback suggests anecdotally 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. However a more comprehensive review of retail costs against gross margins is required to confirm this. Evidence from the information received from retailers does confirm that the cost of the forms of credit that these smaller new entrant retailers are using (cash and pre-payment) are higher than (4-6% on average) than PCGs (0-2%). See Figure 9 for more information.

If this tight operating environment does exist, then one approach suggested by consultees was for retailers to encourage customers to pre-pay or move to some form of advance payment arrangement. Anecdotally there is some evidence that retailers are doing this as some of the consultees suggested that this was a

[1] As at 1st April 2017 there are only four small new entrants with more than 50 supply points.

strategy that they were adopting where possible. Any move to such an arrangement would need to be at the customers' rather than the suppliers' request. Where a tight operating environment exists and retailers are encouraged or driven to place customers on advanced billing, this may constitute an unintended consequence of the credit arrangements.

Market evidence indicates that the current market has a high number of participants in comparison to other markets during the initial stages of market opening (see Figure 12), is not yet highly concentrated (with a HHI of 1,734 on the first of February 2018) and has a limited number of smaller retailers with strategies for organic growth who are growing their market share (see Figure 10). However, the market is also consolidating and much more rapidly than for example the energy supply market did over a similar time period (see Figure 11). This may make entry and expansion more challenging for these smaller entrants and these issues may also force some of the existing smaller players out of the market.

Overall, at this time, limited evidence was found to support a significant change to the allocation of risk in the credit arrangements specifically to support smaller new entrants. Such a change as, at the time of writing, is unlikely to be appropriate as the market had only been open for 12 months and intervention in the credit arrangements specifically to tilt the playing field in the direction of smaller new entrants in this way would be a significant step for which there should be a high bar of evidence that is not currently met. There are already changes happening in the market, for example the Thames time-limited change to the credit requirements and the recent changes established by Severn Trent and Northumbrian Water that will help smaller new entrants. Throughout our review of other sectors no specific examples of credit arrangements that are focussed on supporting new entrants only have been found (see Figure 13). However, if the market continues to consolidate and smaller new entrants begin to exit the market this may increase concentration.

During the course of our work a number of amendments have been suggested to the credit terms that would improve the arrangements for smaller new entrants. A number of retailers suggested that it would be sensible to offer more unsecured credit based on the payment history of the retailer and some also suggested that the reference to the requirement for a credit rating was not consistent with other commercial negotiations they had entered into elsewhere. Wholesalers generally did not object to the proposal that the credit arrangements and the thresholds for unsecured credit could better reflect the underlying risk of the retailer through the use of credit reports. These reports would define the threshold for unsecured credit and this may better reflect the underlying financial risk (e.g. payment history) of the retailer. This would be open to all but would likely help smaller new entrants already in the market as they build their payment history and presence in the market. It would not help those outside the market to enter.

As has been noted, there is a strong link between credit and the gross margins set under the existing PR16 back-stop price controls. Those controls expire in

April 2020 and Ofwat is already considering the appropriate approach to price protection beyond 2020 through its review of the Retail Exit Code.

1.3 Are the credit arrangements clear, consistent and working effectively with the rest of the market arrangements including the self-supply regime?

The new market is still developing and the codes and market arrangements are being tested in a real market environment. Several consultees commented anecdotally that the process leading up to the opening of the market was very time pressured and there was an expectation that arrangements and codes were likely to need to be amended to improve clarity, consistency and drafting during the first year. Changes to the codes are taking place (e.g. CPW019) but overall the evidence suggests that there are opportunities to improve the effectiveness of the credit arrangements.

Based on the interviews, desk review and workshop with market participants several areas have been identified where minor changes could be made to the market arrangements and codes 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 these are set out in the list of proposals at the end of this section.

1.4 How could the credit arrangements be improved to increase benefits to customers from the Non-Household (NHH) retail market?

A number of alternative credit options have been identified either from the discussions with market participants or the desk review of other sectors. Three broad options have been considered:

- Arrangements that would involve a reduction in the overall credit requirements for all retailers (similar to the recent innovation by Thames Water);
- A risk pooling or pooled credit model where retailers would pay into a collective financial arrangements that would provide cover to wholesalers in the event of a default. The ATOL scheme in the travel sector represents one such model; and
- The development of a wholesale risk sharing model that would effectively place the cost of retailer default on end customers by providing a mechanism whereby the cost of a retailer default could be recovered from customers in wholesale charges[2].

A pooled credit model would represent a fundamental shift in the form and nature of the credit arrangements and there would most likely be significant transitional costs associated with moving away from the current model to any alternative. It

[2] This arrangement was also considered as part of the previous Ofwat consultations on credit.

may therefore only be appropriate to consider such a change after full consultation with trading parties, including explicit consideration of any transitional costs and perhaps involving a transitional period. However, based on the qualitative evaluation such a model does appear to offer the potential for a 'win win' change that could potentially both reduce retail credit costs and also reduce wholesale risk exposure. The pooled credit option could therefore be explored further by the code panel as this option 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.

A move to a pooled credit model would represent a material change to the credit arrangements in the codes at a very early stage in the development of the market and could change the overall balance of risk. If the code panel is able to develop an arrangement that it considers holds merit then it would seem sensible that this is consulted on more broadly by Ofwat.

1.5 Next steps

At the time of writing, the Non-Household water retail market had been open for just 12 months and the credit arrangements were established less than a year ago following significant consultation. Given the infancy of the new market there may be a strong need for regulatory certainty and correspondingly there should therefore be a high evidential bar for material changes to the credit arrangements at this time.

Overall limited evidence has been found that would suggest that material changes to the credit arrangements and the balance of risk set out in them are required. Smaller new entrants have raised significant concerns throughout the course of the review but a material shift in the balance of risk cannot be justified at this time, as other changes in the market could help to alleviate these concerns and they may be more adequately addressed as part of any resetting of the existing 'default tariff' price caps post April 2020.

Nevertheless a number of changes to drafting, process or interpretation have been identified that would improve the clarity, consistency or effectiveness of the credit arrangements and should be taken forward at the earliest opportunity.

In considering how arrangements should be taken forward market participants told us that the code panel exists to consider and deliver changes to the codes and should be used as the vehicle for changes in the first instance. However, where changes were material or significantly altered the allocation of risk, many market participants considered that this should be consulted on formally by Ofwat as a material change to the market arrangements.

Figure 1: Proposals to improve the credit arrangements, owners and timescales

Proposals	Owner	Priority	Timescale
Proposals to support a level playing field on credit arrangements			
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. These arrangements could be published in a standard format by MOSL so that there is full transparency, including over the costs of such arrangements. The code panel could 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 and for MOSL to publish all of these arrangements on their website in a common location. Maintaining visibility of these arrangements could help to ensure that trading parties are not in breach of their obligations whilst retaining the opportunity for innovation in the credit arrangements under schedule 3. It may also increase market confidence around the use of PCGs and the existence of a level playing field in relation to them.	Code panel	High	ASAP
Proposals relating to smaller new entrants			
2. Reflecting payment history- The codes panel could 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. The codes panel, or a sub-group, could engage with credit referencing agencies and seek to establish arrangements where the payment histories of different retailers could be obtained and reflected in the credit scoring reports they provide. Ideally these payment histories would reflect retailer payment performance across all wholesalers in the market. The panel could investigate whether the codes could be amended to ensure that the unsecured credit values available for strong payment histories and otherwise strong financial standing could be based on the values taken from these credit scoring reports. Similar changes have been developed in the energy market and there are relationships between this change and others that are currently going through the code panel.	Code panel	High	ASAP

3. Gross margins review- As part of its work to review the appropriate price protection beyond 2020 Ofwat could consider the sufficiency of the gross margins. There were concerns voiced during this study about the gross margins in the market and whether or not the current default tariffs/price controls adequately include allowances for certain costs and taxes. Undertaking and publishing this analysis would allow appropriate challenge and debate ahead of setting such controls.	Ofwat	High	Before January 2019
Proposals to improve clarity consistency or effectiveness of arrangements			
4. Credit assessment scores- The code 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 this doesn't result in a deterioration of retailers credit score. Generally, as per the codes it is the retailers responsibility to provide the credit reports but the code panel could discuss with a credit referencing agency (or group of agencies) whether such reports could be provided independently by the agency to the pool of market participants as and when they are required. This could potentially provide both an independent monitoring party and also an administrative saving to retailers, especially where multiple wholesalers and retailers may be requesting multiple similar reports from the same agencies. Such an arrangement would need to ensure that the requesting of reports did not result in any deterioration in the credit score for retailers.	Code panel	High	ASAP
5. Termination, default and interim supply- Ofwat, the code panel and market participants could take forward some work to test the default, termination and supplier of last resort arrangements in the codes. This might involve holding workshops with market participants to clarify the code arrangements in these areas and to test how these arrangements would work in practise. Any inconsistency in timings arising from this exercise or suggestions to create a staged default process could then be taken forward through the code panel as potential amendments to the codes.	Ofwat, code panel & trading parties	High	ASAP

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.	Trading parties	Low	ASAP
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. 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.	Ofwat	Medium	ASAP
Proposals for broader long-term improvements			
8. Pooled credit models- the pooled credit option should be explored further by the code panel as this option offers the opportunity to deliver significant benefits. If the code panel is able to develop an arrangement that it considers holds merit then we would recommend that this is consulted on more broadly by Ofwat.	Code panel & Ofwat	Low	ASAP

1 Introduction and purpose

This study was commissioned by Ofwat, the economic regulator of water and wastewater services in England and Wales, in order to review the effectiveness of the credit arrangements for the non-household (NHH) retail market which opened in April 2017.

1.1 Introduction and research questions

Retailers entering that NHH retail market must negotiate bi-lateral contracts with each regionally appointed wholesaler that they require water or wastewater services from in order to serve their customers. Each of these wholesalers has a regional monopoly on the provision of these services and they may therefore have both the incentive and opportunity to request credit or collateral requirements from each retailer that might not represent a fair and efficient allocation of risk. To manage this risk a series of credit options were written into the codes for the new market, wholesalers could not refuse services to an entrant that meets any one of these credit or collateral options. The codes in which these credit arrangements are prescribed are subject to a change control process which is overseen by a code panel which is made up of a balanced representation of market participants[3].

Figure 2: Overview of the credit arrangements prescribed into the codes

Credit option	Overview	Code reference
Cash Account	Retailer places cash into account held or nominated by Wholesaler	Wholesale Contract, Schedule 1, Part 2: Business Terms. Schedule 2A: Credit Security Account
Guarantee	Irrevocable, unconditional and continuing guarantee in favour of the wholesaler provided by a guarantor with BBB-/Baa3 credit rating	Wholesale Contract, Schedule 1, Part 2: Business Terms. Schedule 2B: Guarantee
Letter of Credit	Irrevocable standby LoC in favour of the wholesaler provided by an issuer with BBB-/Baa3 credit rating	Wholesale Contract, Schedule 1, Part 2: Business Terms. Schedule 2C: Letter of Credit
Surety Bond	Irrevocable surety bond in favour of the wholesaler provided by an issuer with BBB-/Baa3 credit rating	Wholesale Contract, Schedule 1, Part 2: Business Terms. Schedule 2D: Surety Bond
Unsecured	Reduction in credit cover required to be posted by up to 40% based on retailer credit rating or assessment score	Wholesale Contract, Schedule 1, Part 2: Business Terms. Schedule 2E: Unsecured Credit Allowance
Alternative	Negotiated arrangements which must be published	Wholesale Contract, Schedule 1, Part 2: Business Terms. Schedule 3: Alternative Eligible Credit Support

At the time of writing, the market had been operating for 12 months and a number of concerns have been raised with Ofwat by wholesalers and retailers about the

[3] The Market Arrangements Code, Section 5: The Panel

credit arrangements. They therefore wanted to understand how the credit arrangements were working in practise and what issues trading parties were experiencing. Specifically the study sought to answer four key research questions:

- Is there a level playing field in relation to the credit arrangements?
- Do the credit arrangements represent a material barrier to entry or expansion for smaller entrants?
- Are the credit arrangements clear, consistent and working effectively with the rest of the market arrangements, including in particular the self-supply regime?
- How could the credit arrangements be improved to increase benefits to customers from the Non-Household (NHH) retail market?

1.2 Evidence sources and approach

In order to answer each of the research questions the following sources of evidence have been considered:

- A desk review of a) existing market information (e.g. levels of entry and exit, churn between different entrants, switching rates, etc), b) current and previous code changes relating to credit that have been discussed with the code panel, c) a comparative review of credit and collateral arrangements in other comparative sectors (including the Scottish Water retail market, the UK energy market, the Irish energy market and the smart metering market).
- A series of semi-structured interviews with 11 market participants from the NHH retail market in England including a mixture of wholesalers, different retailers and self-supply entrants (a copy of the aide memoire questions used in these interviews is provided at Annex A).
- A workshop open to all stakeholders where the emerging findings of the work were discussed and debated.
- An information request to market participants to understand a) which credit options are being used and b) the cost of those options both between the different forms of credit and between the different market participants.

The assessment of the research questions and the findings from the study are limited to the above sources of evidence. The study has not undertaken a formal assessment of the overall gross margins in the retail market or indeed the pricing approaches of different retailers or for different retailer groups. This is likely to limit the assessment of particularly the first two research questions.

Each of the research questions is assessed against a clear but generally qualitative assessment framework based on Ofwat’s statutory duties. In particular, the assessment framework considers the potential impacts on consumer protection, levels of effective competition and rivalry in the market, the financeability of efficient wholesalers and the proportionality of the arrangements. The evidence sources highlighted above have been considered in addressing each research question but not all evidence sources are relevant to each of the questions considered.

The study provides a review of the credit arrangements and was undertaken between January and April 2018 but predominantly in February and March 2018. It is not a detailed market study but uses some available market data in the consideration of the research questions.

2 The current structure of the market

This section provides an overview of the current market to inform the four research questions that we have set out in subsequent sections. It includes:

- A brief overview of the market definition as it pertains to the credit arrangements;
- A brief overview of the market structure including the number and type of retailers in the market, levels of entry over time, market shares and different retailer strategies as suggested in their licence application process; and
- A brief overview of the credit arrangements, including the arrangements used by different types of retailer and the volume of wholesale charges covered by different arrangements.

2.1 Market definition

The NHH market covers a range of retail activities, including billing, customer contact, debt management and other services[4]. The market systems clearly delineate separate services for water, wastewater and non-primary charges. Non-primary charges are not taken into account when calculating the credit support requirement and therefore are deemed out of scope of this review. The credit support requirements are common between water and wastewater markets and the review has not attempted to define each of these different markets. However, it is noted that:

- **Some retailers also earn unregulated revenues from complementary services**- regulated market arrangements and associated default tariffs[5] do not cover all the activities and services that retailers operating in the market provide to their customers. There are a number of 'unregulated' complementary services for example water efficiency advice or data and information management services, from which some retailers have told us that they are earning additional revenues beyond the gross margins established in the PR16 controls;
- **Some retailers earn revenues from other regulated markets**- some of the retailers operating in the market have suggested that they draw revenues from other markets, in particular the Scottish retail market; and
- **This is a national market but with regional character**- whilst retailer licences allow them to switch and provide services to eligible customers across England and Wales the market is made up of 23 different wholesalers and the wholesale charges, gross retail margins under the PR16 price controls and operational interfaces differ between wholesalers so the market may have a regional character.

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[4] For a full list of the associated services and costs that were separated from incumbents see RAG 2.07 section 2.4
[5] For further information on business retailer price controls see PR16 final determinations

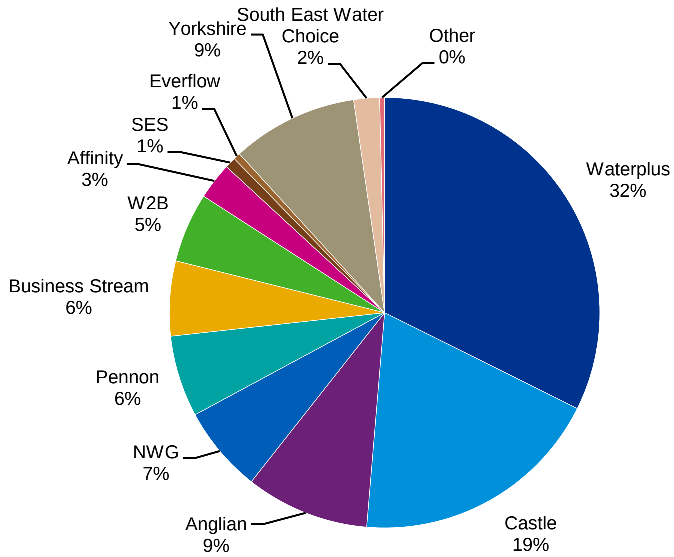
2.2 Market structure

The market is currently comprised of 30 retailers, although only 12 of these have a market share of around 1% or above, that interact with 23 wholesalers for the provision of retail services to 2.7m supply points or customers. The 30 retailers can be broken down as:

- 18 are ‘initial in area retailers’. Initial in-area retailers are retailers who entered the market on 1 April 2017 with an existing customer base either because they are former incumbents or because they acquired the customer base of a former incumbent. Many of these retailers represent the ‘associates’ of existing appointed water companies, i.e. the incumbent companies have passed their existing customer bases to a new associate company within the group that now competes in the market. Two of these ‘initial in area retailers’ are large trading parties that have joined the market and chosen a strategy of growth through acquisition of one or more existing customer bases from the former incumbents and have significant market share in the wholesale areas in which they have acquired a customer base.
- Nine of the retailers represent ‘new entrant retailers’ that appear, based on the strategies provided to Ofwat as part of the licence granting process, to have joined the market either with a strategy of organic growth or the provision of certain niche services. Three of these ‘new entrant retailers’ have joined the market from established positions in other similar regulated utility retail markets (e.g. the Scottish water market or energy retailing); and
- Three retailers represent self-supply retailers. All the current self-supply retailers in the market are large businesses who have significant number of sites and water demand volumes.
- Concentration has increased since market opening. On the 1st of February the market had a HHI[6] of 1,734 in terms of supply points. This may represent a moderate level of concentration but a significant increase in concentration since market opening when the former distribution of customers across the regionally appointed companies would have had a HHI of around 1,202.

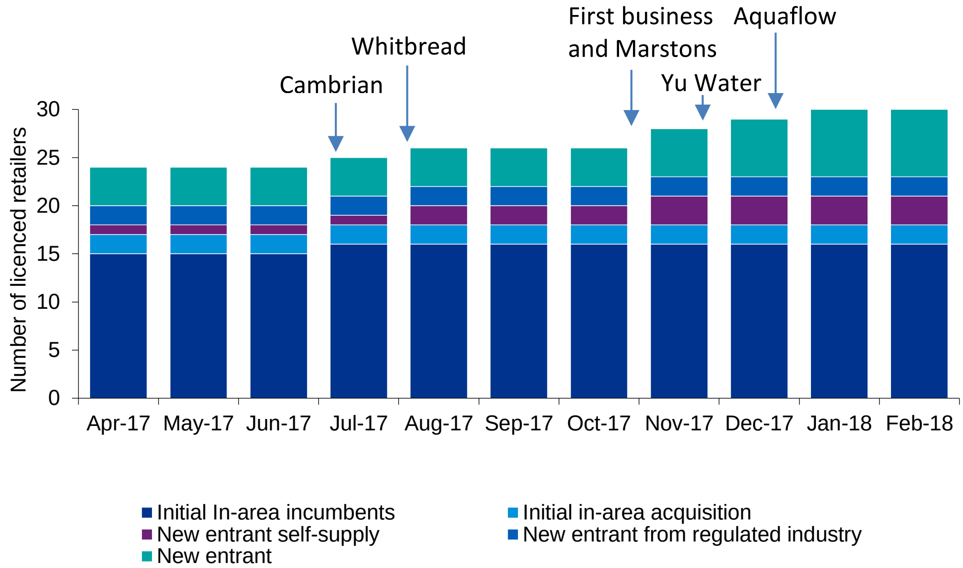
[6] The HHI or Herfindahl–Hirschman Index is a measure of the size of firms in relation to the industry and an indicator of concentration or the amount of competition among firms. It is defined as the sum of the squares of the market shares of the firms within the industry, where the market shares are expressed as whole percentages, the index ranges from 0 to 10,000 "points". A HHI below 1,500 indicates an unconcentrated industry one between 1,500 to 2,500 indicates moderate concentration and a HHI above 2,500 indicates high concentration.

Figure 3: Market shares at 1st of February 2018



Source: KPMG analysis using market data from [MOSL Market Performance]

Figure 4: Cumulative market entry since market opening in April 2017



Source: KPMG analysis using [Ofwat licensing data]

Retailers can compete nationally across England and Wales for certain customer types but the market is made up of a number of different wholesale regions.

All retail licence holders must provide business plans and strategies to Ofwat as part of the process of granting licences. A summary of these strategies have been provided to us by Ofwat, which suggests that:

- A number of the initial in area retailers' strategies are focussed on:
  - customer retention in their existing areas in the first instance;
  - acquiring new customers by extending water only customers to sewerage services also or obtaining multi-site customers where they hold an existing relationship; and
  - partnering with third parties such as independent energy suppliers to offer multi-utility or bundling services.
- New entrants are employing a much broader range of strategies including:
  - targeting customers nationally;
  - using Third Party Intermediaries (TPIs) to minimise overheads; and
  - focussing on different customer groups- some focussing on larger or multi-site customers and some focussing on Small and Medium-sized Enterprises (SMEs).

At the time of writing well over 90% of the in area supply points in all wholesale areas remain with the relevant initial in area retailer.

2.3 Current credit and collateral use across the market

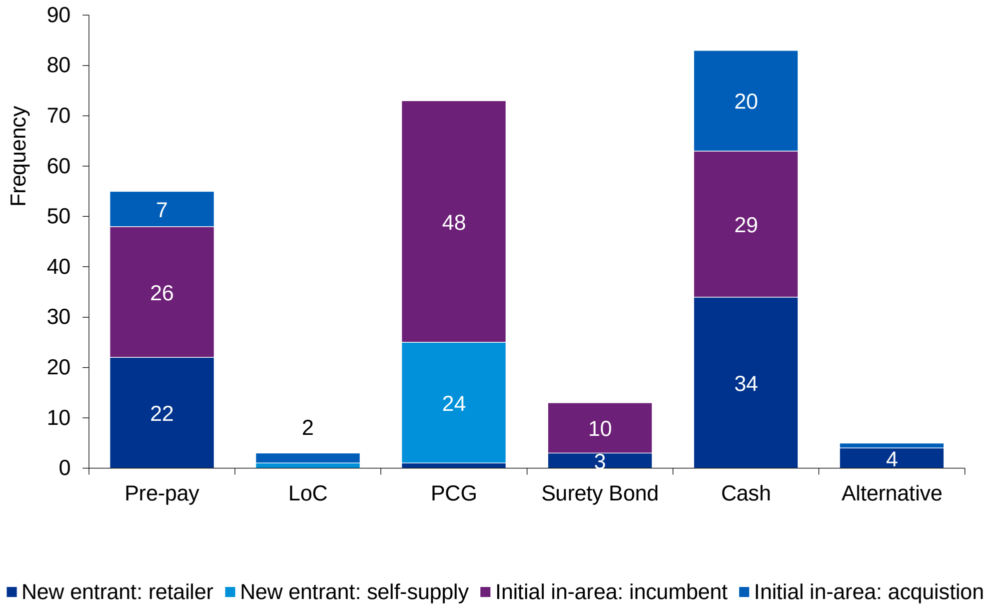
When a new entrant joins the market they must negotiate the credit and collateral arrangements that they put in place with each wholesaler. These agreements are not published (unless the wholesaler agrees to a new arrangement which is not prescribed under the codes, known as a 'schedule 3' arrangement). Across these different entrants, based on the information request and consultations, it appears that:

- all of the current credit arrangements are being used by some retailers in the market, the most commonly used arrangements appear to be cash collateral for post payment and some form of guarantee but pre-payment is also widely used;
- initial in-area incumbent retailers are typically using Parent Company Guarantees (PCGs) for their in area arrangements and cash or pre-payment for out of area customers but some are also using the surety bond or guarantee options in area;
- initial in-area acquisition retailers, which represent entrants who have acquired a customer base, are typically using Letter of Credit for their in area arrangements and cash or pre-payment for their out of area arrangements;
- new entrant retailers are typically using cash or the pre-payment options, in some instances they have been able to negotiate an alternative 'schedule 3' arrangement; and

- self-supply retailers are all using guarantees under post-payment and did not report using pre-payment, surety bond or cash on deposit arrangements.

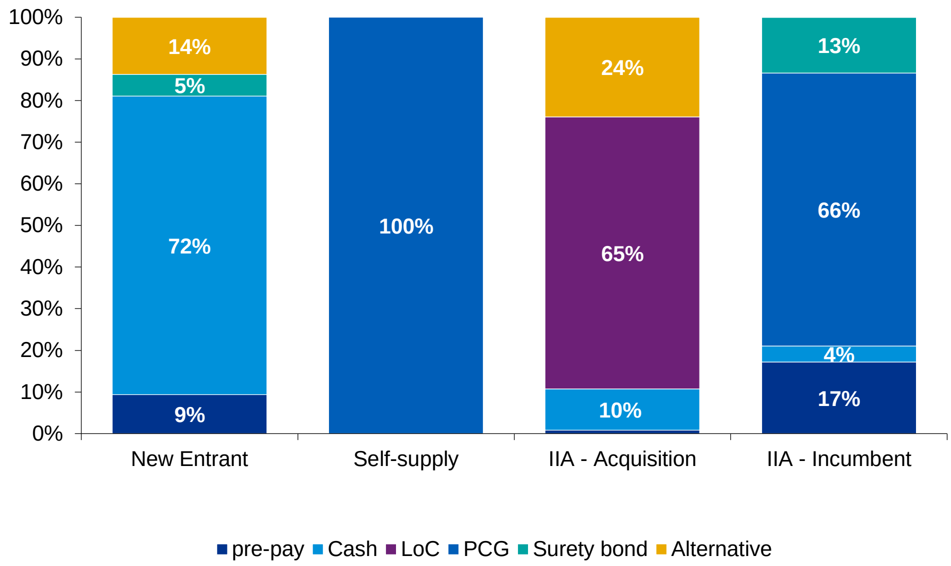
Figure 5 shows the reported frequency of the different credit options used by retailers in the market according to the different retailer types and figure 6 shows the proportion of wholesale charges (shown as a % of P1 values) covered by each credit type again by different retailer type.

Figure 5: Reported frequency of bi-lateral credit arrangements in place by retailer type



Source: This information was provided to KPMG by Ofwat from companies in response to a formal request for information. Data has been aggregated and anonymised to avoid identification of any specific retailer and consents to publish have been agreed between Ofwat and retailers.

Figure 6: Reported % of P1 values by credit and retailer type



Source: This information was provided to KPMG by Ofwat from companies in response to a formal request for information. Data has been aggregated and anonymised to avoid identification of any specific retailer and consents to publish have been agreed between Ofwat and retailers.

2.4 Conclusions

The NHH market covers a range of retail activities, including billing, customer contact, debt management and other services. The market systems clearly delineate separate services for water, wastewater and non-primary charges. Non-primary charges are not taken into account when calculating the credit support requirement and therefore are deemed out of scope of this review. The credit support requirements are common between water and wastewater markets and the review has not attempted to define each of these different markets.

The market is currently comprised of 30 retailers, although only 12 of these have a market share of around 1% or above, that interact with 23 wholesalers for the provision of retail services to 2.7m supply points or customers. 18 are 'initial in area retailers', nine of the retailers represent 'new entrant retailers' that appear to have joined the market either with a strategy of organic growth or the provision of certain niche services, three retailers represent self-supply retailers.

Concentration has increased since market opening. On the 1st of February the market had a HHI of 1,734 in terms of supply points. This may represent a moderate level of concentration but a significant increase in concentration since market opening when the former distribution of customers across the regionally appointed companies would have had a HHI of around 1,202.

Across these different entrants, based on the information request and consultations, it appears that:

- all of the current credit arrangements are being used by some retailers in the market, the most commonly used arrangements appear to be cash collateral for post payment and some form of guarantee but pre-payment is also widely used;
- initial in area retailers are typically using Parent Company Guarantees (PCGs) for their in area arrangements and cash or pre-payment for out of area customers but some are also using the surety bond option in area and there are some alternative credit arrangements in place;
- those initial in area retailers that represent entrants who have acquired a customer base are typically using Letter of Credit or a Guarantee for their in area arrangements and cash or pre-payment for their out of area arrangements;
- new entrant retailers are typically using cash or the pre-payment options, in some instances they have been able to negotiate an alternative 'schedule 3' arrangement;
- self-supply retailers are all using guarantees under post-payment and did not report using pre-payment, surety bond or cash on deposit arrangements; and
- unsecured credit was accessed almost exclusively by initial in area retailers and self-supply retailers.

3 Is there a level playing field in relation to the credit arrangements?

To address this research question the evidence has been considered against two further questions:

- Is the provision of credit and collateral by retailers a normal feature of regulated retail or supply markets?
- Is there a level playing field in the provision of credit and collateral arrangements?

The overall approach adopted to answer these research questions has been limited to:

- undertaking some analysis of the credit arrangements currently operating in the market based on an Ofwat information request to all retailers (which is described in section 2);
- comparing the credit arrangements with certain other sectors to identify any major differences; and
- identifying any issues of concern based on the market interviews.

Our conclusions and observations in relation to the above research questions are limited to the insights and findings from these three steps only. In particular our assessment has not included a review of the gross margins and retail costs or pricing in the market.

3.1 Is the provision of credit and collateral by retailers a normal feature of regulated retail or supply markets?

All new entrants joining the market must negotiate their credit and collateral arrangements with each of the 23 wholesalers if they want to switch customers in their areas.

Only one of the consultees considered that retailers should not be required to provide credit or collateral cover and this point was also supported by a small number of smaller retailers in the workshop. They argued that:

- such collateral would not have been required under the previous integrated company arrangement prior to the opening of the market or that the wholesalers have reduced their risk as a result of retail separation (either because the cash collection rates had improved following the opening of the market or because certain key risks had transferred to the retailers); or
- that Ofwat already undertakes a financial viability assessment of all licence holders so this should be sufficient.

All of the other consultees considered that some form of credit or collateral cover was entirely right, even if they disagreed with the form or value of that credit in different circumstances.

Figure 7 provides a summary of those arrangements. Overall the review suggest that the credit requirements in the codes are similar to those offered in other regulated markets, with a similar mix of credit options and cover. However, the current market arrangements allow a larger proportion of unsecured credit cover, subject to certain conditions, than other markets.

Figure 7: Credit and collateral arrangements in other sectors

	DCUSA[7]	CUSC[8]	BSC[9]	SEC[10]	Scottish Water[11]	Irish Power[12]	Gas UNC[13]	NHH Water Retail
Credit Cover	Total value at risk + 15 days	BSUoS = 32 days TNUoS = VAR & forecast	29 days plus additional 20%	1 month plus unpaid charges	2 months	Actual and forecasted liabilities for a month	Value at risk + 20 days	50 days
Credit Options	Cash, LoC, Guarantee	Cash, LoC, Guarantee, Insurance Bond	Cash, LoC, Insurance Product	Cash, LoC, Guarantee	Pre-payment	Cash, LoC	LoC, Guarantee, Deposit Deed	Pre-payment Cash LoC Guarantee Surety bond
Negotiated option	No	Yes	No	No	No	No	No	Yes
Unsecured credit	Max 2% RAV: Credit rating, score or payment		No	Credit assessment value	No	No	Max 2% RAV: Credit rating, score or payment	Max 40%: credit rating or score

Source: KPMG analysis from market documentation

[7] The Distribution Code Use of System Agreement (DCUSA) is a multi-party contract between licensed electricity distributors, suppliers and generators in GB Energy Market. District Network Operators (DNO) set charges for the connection and use of the 14 distribution networks to suppliers. Credit terms under the DCUSA arrangements provides security of payments for charges for the total value at risk plus 15 days.
[8] The Connecting and Use of System (CUSC) is a trading code between licensed electricity generators, suppliers and the National Grid. Charges recover both the cost of installing and maintaining the transmission system and the balancing of the grid. Generators are charged according to their capacity and suppliers based on their forecasted demand. Credit requirements provides security for payment of transmission use and balancing services covering either 32 days for balancing or for transmission the value at risk plus forecasting performance.
[9] The Balancing and Settlement Code (BSC) is a trading code between Elexon, generators and supplies and covers how payments are made with Elexon acting as a clearing house to cover differences between generation and consumption forecasts and actual results. Credit arrangements cover at least 80% of payments made through Elexon to ensure that there is sufficient liquidity to cover these payments in the case of default.
[10] The Smart Energy Code (SEC) is a trading code between the Data and Communications Company (DCC), energy suppliers, network operators and other relevant stakeholders' parties in the UK Energy Market. Each party to the SEC is invoiced by the DCC at the end of each month to fund its operation and the credit arrangements cover the value at risk. This is the sum of charges invoiced but not yet paid plus forecasted charges for the next invoice.
[11] The Scottish Water code is a trading code between retailers in the Scottish Water Market and licensed suppliers. Licensed suppliers are required to pre-pay two months of charges with Scottish Water paying 4% interest on that pre-payment.
[12] The Irish Power code is a trading code between two system operators, generators and suppliers for the Republic of Ireland and Northern Ireland. Credit cover requirements are based on actual and forecasted payment liabilities for each supplier.
[13] The Gas UNC (UNC) is a trading code between the four independent GB gas networks. Credit arrangements provide security the spot market clearance payments and transportation costs in case of default covering the aggregate invoice amount plus 20 additional days of cover.

3.2 Is there a level playing field in the provision of credit and collateral arrangements?

The data request information demonstrates that within the current market structure, the associated retailers of former incumbents are using a mixture of credit options. Often they are making use of PCGs, particularly in those wholesale areas where the majority of their customers are located or where they have had the customer base previously served by the appointed incumbent transferred to them.

One of the more significant concerns raised through the consultations was around the use of PCGs by former incumbents or initial in area retailers and the extent to which there was a level playing field in the use of credit options. In particular there was a concern that these guarantees represent one of the cheapest forms of credit and that they were being used largely by existing associated retailers (i.e. former incumbents) who are more able to access them than smaller new entrants by utilising their group structures and relationships.

A PCG constitutes a contingent liability on the parent company. The cost of the PCG will not appear in the financial statements of the retail subsidiary if the parent company does not charge the retail subsidiary for the PCG. Nonetheless, there remains a cost implication at the group level for extending the PCG where the retail subsidiary subsequently provides guarantees on to external parties. This in theory would affect the overall group credit position and any credit rating held, and would reduce the borrowing capacity of the group. However, in instances where the PCG, or indeed some other form of credit, is intra-group between a wholesaler and its retail subsidiary (i.e. retail credit risk is shared between the wholesaler and the retail subsidiary) the result is that retailers who are associated with wholesalers in the same group may accrue a benefit in comparison to other retailers as a result of their ability to internalise the costs associated with different credit options, including PCGs. This could create an opportunity for associated incumbent retailers to price below the efficient costs of a new entrant as a result of lower credit costs.

There has been a recent code change that will stop retailers from accessing unsecured credit according to the credit rating of their parent company (rather than their own financial standing)[14]. This change is unlikely to address the issue discussed above because it simply clarifies that the PCG must be provided by the relevant entity and removes a previous reference that suggested that where a holding company holds an investment grade credit rating the formal PCG would not be needed.

Separately, consultees raised an alternative concern about schedule 3 or alternative credit arrangements. In particular a concern was voiced that some wholesalers appeared to have agreed to alternative credit arrangements that

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[14] CPW 018: See: https://www.ofwat.gov.uk/publication/wholesale-retail-code-change-proposal-ref-cpw018/

were not published. Furthermore, a concern was raised that, in some instances, 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.

3.3 Evaluation and proposals

Where the market arrangements favour a particular retailer then this would constitute an un-level playing field.

It is clear from the data request that whilst it is the case that PCGs are mostly being used by former incumbents, they are not exclusively being used by them. Self-supply retailers also make use of these arrangements and at similar costs. It is possible that these arrangements could create an opportunity for an advantage to be conferred to these associated incumbent retailers but this would depend on how those retailers choose to respond to the issue and the prices offered to their customers on which we have no evidence.

Based on the evidence it does appear that there is a potential opportunity for the retail prices offered by associated former incumbent retailers to be non-cost reflective. This reflects the opportunities created by intra-group credit arrangements to gain access to credit at more favourable terms. However, there is no information as to whether they have taken advantage of this lower cost of credit in their commercial offers to end-customers and the detailed arms-length arrangements that different retailers have put in place have not been examined through this work.

There are a range of responses that could be taken to address this issue, if further investigation suggests that action is necessary. This could include, for example, softer responses requiring more transparency over these arrangements, ex-ante changes to the credit arrangements and the use of PCGs or ex-post investigations into the market by the regulator. Our proposals in other areas might help to allow independent entrants access to cheaper costs of credit which could help but in the absence of any more evidence greater transparency may be a more appropriate approach until the issue becomes clearer.

The alternative credit arrangements in the market allow trading parties to enter into new arrangements where both parties agree to them outside of the other regulated offers that wholesalers must accept. Where these new arrangements are agreed this can represent a healthy evolution of the credit arrangements in line with the requirements of trading parties. The requirement to publish those offers seeks to enable the same offers to be available to other retailers with a similar credit risk. Where these arrangements are not transparent or are designed in a way that makes them so bespoke to particular retailers that they could not be offered to others with similar credit risk this would increase 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. These arrangements could be published in a standard format by MOSL so that there is full transparency, including over the costs of such arrangements. The code panel could 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 and for MOSL to publish all of these arrangements on their website in a common location. Maintaining visibility of these arrangements could help to ensure that trading parties are not in breach of their obligations whilst retaining the opportunity for innovation in the credit arrangements under schedule 3. It may also increase market confidence around the use of PCGs and the existence of a level playing field in relation to them.

4 Do the credit arrangements represent a material barrier to entry or expansion for smaller entrants?

To address this research question the evidence has been considered against two further questions:

- Does the amount of credit required represent a material barrier to entry or expansion for smaller new entrants?
- Is there a case for specific provisions to be included in the credit arrangements for smaller new entrants?

The overall approach adopted to answer these research questions has been limited to:

- understanding the perspectives and arguments of different market participants to these questions based on the market interviews;
- undertaking some analysis of the credit arrangements currently operating in the market based on an Ofwat information request to all retailers (which is described in section 2);
- comparing the credit arrangements with certain other sectors to identify any specific arrangements offered to smaller new entrants; and
- other evidence on the market structure based on existing market data.

Our conclusions and observations in relation to the above research questions are limited to the insights and findings from these four steps only. In particular our assessment has not included a review of the gross margins and retail costs or pricing in the market of these smaller new entrants.

4.1 Does the amount of credit required by the codes represent a material barrier to entry and expansion for smaller new entrants?

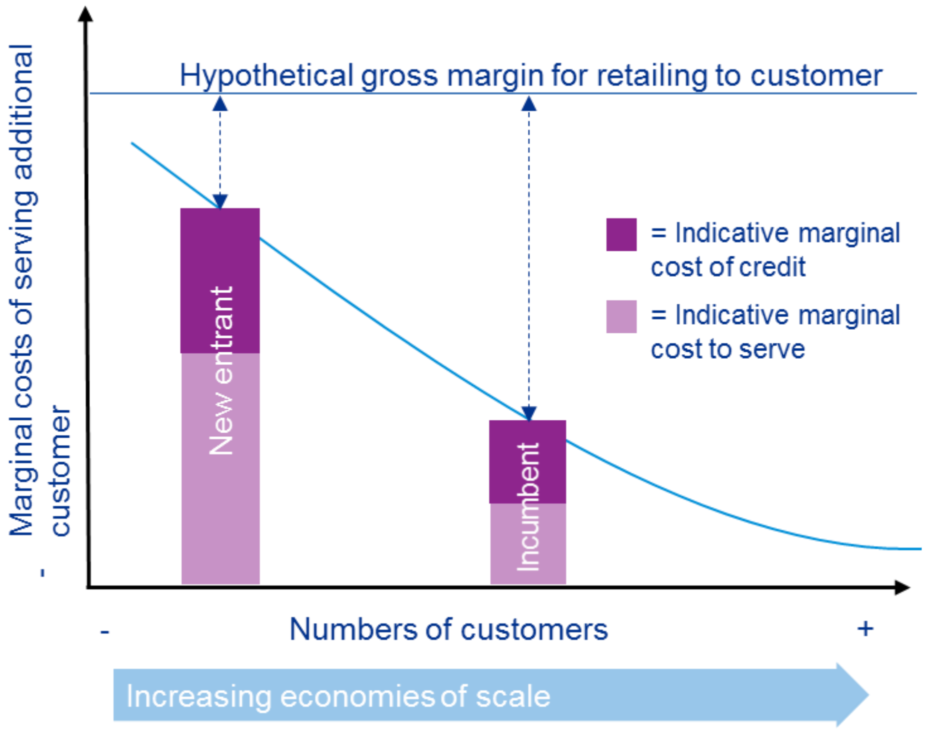
4.1.1 Key findings from the interviews and workshop

Virtually all of the consultees at the workshop and interviews commented that the gross margins (allowed costs plus net margins under the PR16 price caps) in the market were thin and that credit and collateral requirements further reduce the available margins. There was a high degree of consensus that these margin issues would likely be worse for smaller new entrants with a strategy of organic growth. This is because they may not be of sufficient size to take advantage of the scale economies necessary to provide a sufficiently low cost to serve customers compared to larger players and because the credit options available to them, without a long trading history or from being part of a larger group, would likely be more expensive on a per customer basis.

Figure 8 shows a stylised graphic of this effect, whereby the cost to serve a marginal customer by a smaller new entrant may be higher than that of a more established player.

It is clear from the evidence collected from retailers through the information request that smaller new entrants are using more expensive forms of credit that other market participants but no analysis has been undertaken as part of this study into the cost to serve of different retailers.

Figure 8: Potential cost and margin advantages of having scale in the new market



The existence of significant scale economies in retailing was widely accepted amongst the consultees approached through the study. Indeed one of the retail consultees suggested that as part of their strategy for entering the market they had identified that scale was so important that they had decided that they must acquire a large customer base from an existing company in order to compete effectively. Another initial in area retailer highlighted that, despite already having a substantial existing customer base from the former appointed company, they still considered that they needed to join with another large retailer in order to acquire sufficient scale in the market to compete.

During the workshop discussions a number of parties made comparisons with other regulated markets that they operate in where credit arrangements were more onerous than the English water retail market but because the overall gross margin was higher they could still operate effectively. There was also a view given by several trading parties that the credit arrangements were not the key issue and in fact it was the overall gross margins under the PR16 price caps that needed to be reviewed.

Several of the consultees also 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, including the credit and collateral costs, marketing and customer acquisition costs and Market Operator fees[15]. They also considered that the previous analysis, undertaken as part of the original work to define the credit arrangements, did not adequately consider Value Added Tax and that retailers were currently incurring significant costs to 'clean up' customer data which should have been cleaned by wholesalers.

All of the smaller new entrants stated both in the consultations and during the workshop that the cost of credit was a material issue for them.

If this tight operating environment does exist, then one approach suggested by consultees was for retailers to encourage customers to pre-pay or move to some form of advance payment arrangement. Anecdotally there is some evidence that retailers are doing this as some of the consultees suggested that this was a strategy that they were adopting where possible. Any move to such an arrangement would need to be at the customers' rather than the suppliers' request. Where a tight operating environment exists and retailers are encouraged or driven to place customers on advanced billing, this may constitute an unintended consequence of the credit arrangements.

Consultees also highlighted a range of other barriers to entry that would affect new entrants, particularly smaller new entrants, including:

- the complexity of entering the market, including the complexity of the regulatory framework and the obligations on new entrants and the complexity of the charging regimes;
- the difficulty of engaging with many wholesalers all with different wholesale arrangements and wholesale portals and different interpretations of the codes; and
- the advantages of initial in area retailers in terms of the data held on the customer.

4.1.2 Key findings from the data request

In order to understand not only which credit options were being used by different parties but also the cost of those options, including for smaller new entrants, Ofwat issued an information request to all retailers in the market.

The data request asked retailers to specify their cost of credit by type of credit arrangement. Retailers were asked to break their credit costs into fixed and variable components. Fixed costs include, for example, upfront arrangement fees and recurring commitment fees. Variable costs are costs incurred on a pence per pound of credit utilised. All but three of respondents reported incurring no fixed costs, two of which also provided variable costs. For the one respondent incurring

[15] Comments about the overall gross margins in the NHH retail market in England have been made before. For an exposition on these issues see consultation on the review of non-household retail price controls

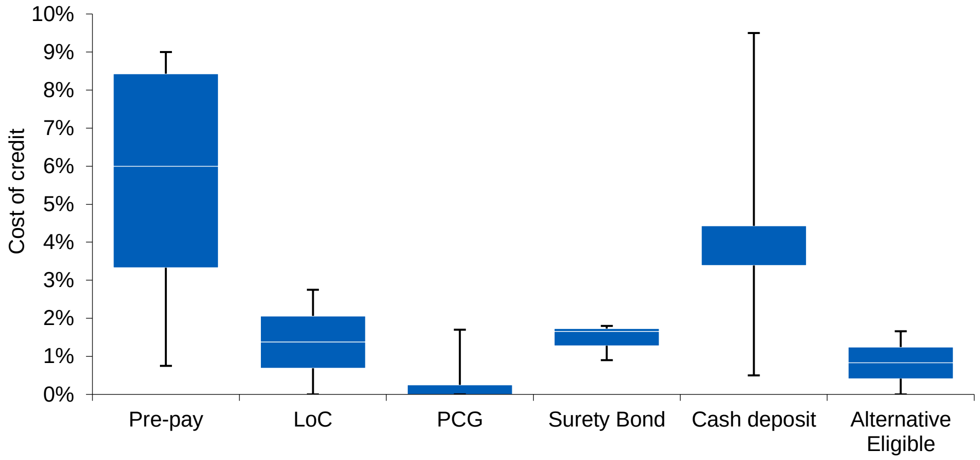
fixed costs, their fixed cost was converted into a pence-per-pound basis for comparability.

The chart below shows credit costs by the type of credit arrangement on a pence per pound of credit utilised basis. For each type, the line shows the min and max range while the box shows the interquartile range.

Overall, pre-payment and cash deposit are the most expensive forms of credit. Retailers report credit cost ranging from 0.75 – 9% for pre-payment and 0.5 – 9.5% for cash deposit. The wide ranges reflect different cash sources. The low end of the range corresponds to bank lending rates for retailers with access to bank borrowings. The high end of the range corresponds to the cost of equity where retailers rely on cash injection from their shareholders.

A majority of retailers report no costs associated with a Parent Company Guarantee. This is likely to be as a result of their intra-group arrangements and not reflective of the true economic cost of the PCG. However, there is no basis to estimate PCG costs based on the responses from retailers.

Figure 9: Analysis of credit costs across different options (max, min, median and interquartile ranges)



Source: This information was provided to KPMG by Ofwat from companies in response to a formal request for information. Data has been aggregated and anonymised to avoid identification of any specific retailer and consents to publish have been agreed between Ofwat and retailers.

Overall, it is clear from the data request that whilst there are a wide range of costs for different credit options and significant variance within different credit options pre-payment and cash deposit options carry much more significant credit costs than alternatives. As can be seen in Figure 6 these credit options represent c.81% of the P1 values for new entrant retailers but just 17% of the P1 values of initial in area incumbent retailers and 10% of the P1 value of initial in-area acquisition retailers.

4.2 Is there is a case for specific provisions to be included in the credit arrangements for smaller new entrants?

4.2.1 Key findings from consultations

Most of the consultees and workshop participants considered that there was not a strong case for specific provisions to be included in the codes to reduce the credit and collateral arrangements for smaller new entrants specifically. In particular they highlighted:

- the number of new entrants into the market and the level of competition, including smaller new entrants since the market opened;
- that there is some evidence of smaller new entrants being able to join the market and attract customers, querying the materiality of the cost of credit issue;
- that the real entry barrier was the cost to serve or economies of scale of larger players and that this was a natural barrier to entry;
- the overall discount offered for post-payment under the codes currently (c.40%) compared to other sectors and that this should be sufficient;
- the opportunity for wholesalers to reduce collateral for retailers and the benefit to wholesalers from a more diverse range of retailers to spread the risk of retailer default;
- the risk to customers associated with default arising as a result of reducing the credit requirements of new entrant retailers; and
- the wider changes happening in the market, for example the recent Thames water provisions to provide up to c.£83k free credit to all retailers per settlement period, which are likely to help smaller new entrants.

During our discussions with market participants they highlighted three potential changes to the codes that could be made, these changes would be open to all providers but may help smaller new entrants in relation to the cost of credit:

- **An allowance to reflect the reduced risk of a strong payment history-** the codes currently do not provide any improved credit arrangements if the retailer has a strong payment history. Some market participants considered that this could be included in the codes, for example by using the lending values provided by some credit reports to set unsecured credit values.
- **An amendment to the codes to allow access to unsecured credit allowances where a credit score exceeds c.90 rather than where a retailer has an investment grade credit rating**- There was a concern that retailers would not be able to achieve an investment grade credit rating and that this requirement was not appropriate, some of the consultees we spoke to suggested that using credit scoring reports was more appropriate. One suggested that where a credit score exceeded 90 and therefore the retailer had no ‘markers’ against them in the credit report (e.g. for failing to pay an invoice), then an allowance should be made for unsecured credit.

- **An allowance where retailers take strategies based on targeting low risk customers**- For example, where a retailer chooses to target ‘blue chip’ customers that may be seen as at lower risk of late or non-payment. Although there was less clarity around how this could be included, some retailers considered that this could be covered by insurance but most of the group considered that an insurance policy covering retailers for customers defaulting on their payments was not something wholesalers could take comfort from.

There have also been some specific code changes brought before the code panel by smaller new entrants such as CPW019. CPW019 seeks to introduce a credit option which included the use of a credit insurance policy taken out by the retailer against non-payment by their customers that would then allow that retailer to access a proportion of unsecured credit. This may have some similarities with the last suggested change noted above.

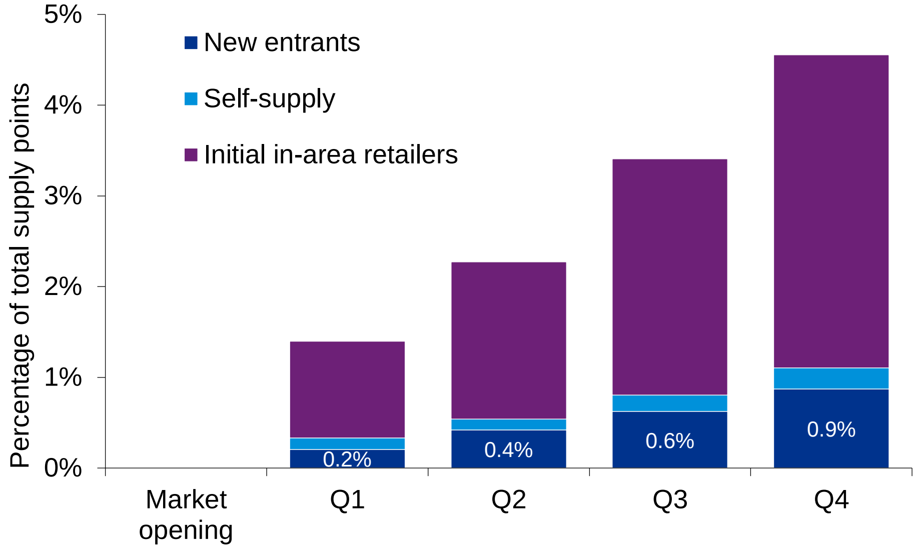
4.2.2 Comparative evidence from other markets

To draw evidence form other markets the following characteristics have been reviewed:

- the growth in independent new entrants versus ‘non-big 6’ in the energy supply market;
- the pace of consolidation in the NHH water retail market to the energy supply market in the UK in the similar period after its opening; and
- the levels of entry in the NHH water market with other markets the results can be seen below.

The analysis in Figure 10 shows that smaller retail entrants have grown to around 0.9% of supply points during the first year. In the energy supply market, including both domestic and non-domestic customers, non- Big 6 retailers grew their market share from c.1% in 2012 to c.20% in 2018.

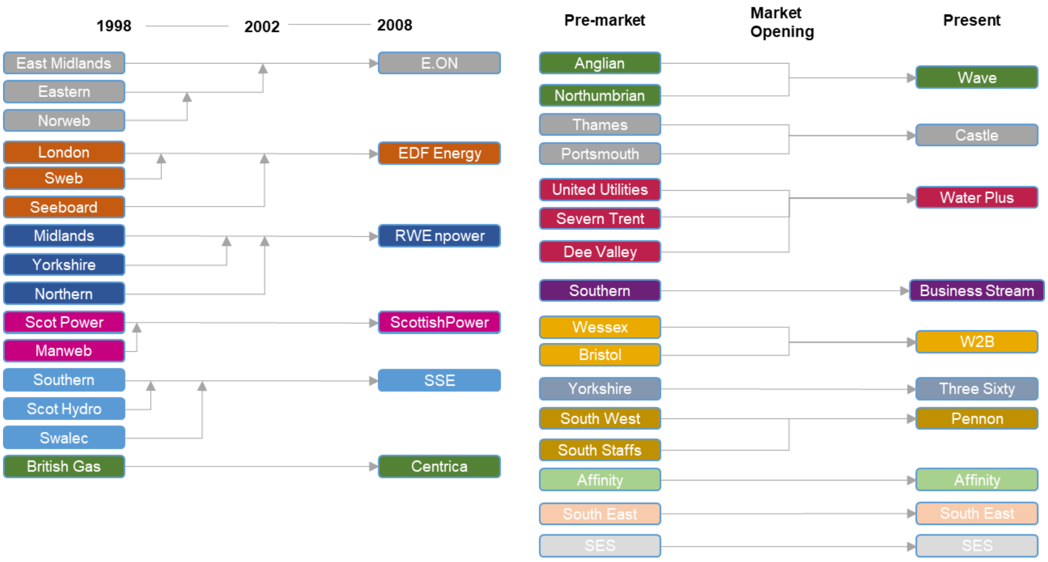
Figure 10: Percentage of total supply points switched in NHH Water retail market (Apr 2017-Mar 18)



Source: Data provided by Ofwat

A comparative review of the water retail market against the energy supply market in Figure 11 suggests that the Water retail market is not as concentrated as energy supply but is consolidating much more rapidly than the energy supply market did during a similar period since market opening (where consolidation to the 'big six' took around 10 years). Whilst initial consolidation in the energy retail or supply market appears to have taken many years and much longer than appears to be the case in the NHH retail water market, it is notable that more recently there has been significant growth in smaller new entrants and this may continue. Hence the trend towards consolidation has not been linear over the long-term.

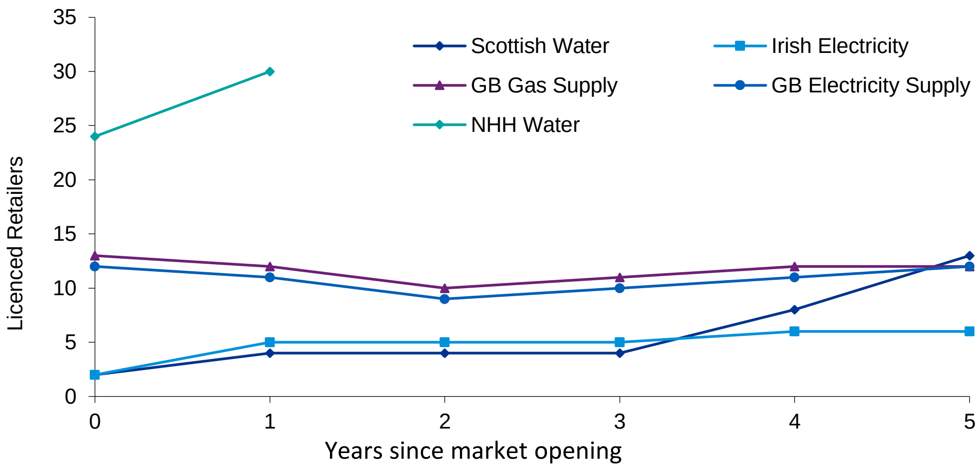
Figure 11: Market consolidation in energy supply versus NHH water retail in England post market openings



Source: KPMG analysis using Defra retail exit data and Ofgem retail probe

Licensing data also shows that levels of entry into the NHH retail market are much higher than comparable sectors, albeit that around half of the licence holders are represented by former incumbents. This is shown in Figure 12.

Figure 12: Levels of entry in the NHH retail market versus other sectors



Source: KPMG analysis using licencing data from utility regulator, commission for regulation of utilities, Ofgem, and Ofwat

The extent to which the arrangements in other comparable sectors included special provisions for smaller new entrant retailers was also examined. Figure 13 summarises our findings.

Figure 13: Credit arrangements in comparable markets that may support smaller new entrants

	DCUSA	CUSC	BSC	SEC	Scottish Water	Irish Power	Gas UNC
Provisions which may benefit smaller new entrants	DCUSA up to 0.4% annual unsecured credit available based on payment history		None	Unsecured credit based on guarantor credit rating	None	None	Profiling payments

Source: KPMG review of relevant market arrangements.

The evidence from other sectors does show that there are some examples of provisions that may assist smaller new entrants but nothing that is specifically targeted at supporting smaller new entrants uniquely. The specific provisions include:

- The DCUSA code allows unsecured credit to be accessed up to 2% of Regulatory Accounting Value (RAV or RCV) based on credit rating and payment history (although retailers here do not have an RCV);
- The SEC allows a value of unsecured credit based on the guarantor's credit rating (similar to the unsecured credit arrangements in the NHH retail water market); and
- The Gas UNC offers the profiling of payments over time if the trading party meets certain requirements and experiences difficulty in paying their charges.

4.3 Evaluation

The provision of credit and collateral cover is a common feature of other markets that were reviewed and a natural entry barrier. The credit arrangements set out in the codes are similar to those observed in other markets in terms of the form and scale of credit required. The different types of credit that can be accessed are not necessarily available to all retailers, including smaller independent new entrants, but where this reflects only their level of risk this would be in line with the purpose of the credit arrangements.

Whether a new entrant can join the market and compete for customers against other suppliers we assume is largely a function of the quality of service they offer and the costs they incur in serving new customers, including the cost of credit. In the NHH retail market the success of any new entrant may therefore depend on the service they offer and the extent to which they can serve customers at a lower cost than their competitors to provide lower prices. In the regulated NHH retail market back-stop 'default tariffs' continue to exist and these price controls may also create a maximum cap for retailers.

Consultees that were interviewed indicated that there are significant scale economies in providing services to customers in the NHH retail market, i.e. that the marginal cost of providing services to additional customers declines as the number of customers served increases. The market data also confirms that the market is consolidating faster than the energy supply market did over a similar timeframe which could also be an indication of the existence of these scale economies.

In this environment entry for smaller retailers who have a strategy for organic growth through customer switching, rather than for example growth through acquisition, may be more challenging because they may lack the scale economies of more established players. This may create a market environment that is more concentrated with a smaller number of much larger players and fewer new entrants. In a market with these characteristics customers may still benefit from lower prices and improved service, for example, from competition amongst larger players with those scale economies.

It is not possible to examine the materiality of the impact of the credit arrangements. Feedback provided to us 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. However a more comprehensive review of retail costs against gross margins is required to confirm this. Evidence from the information received from retailers does confirm that the cost of the forms of credit that these smaller new entrant retailers are using (cash and pre-payment) are higher than (4-6% on average) than PCGs (0-2%).

Market evidence indicates that the current market has high levels of entry in comparison to other markets, is not yet highly concentrated (on a HHI basis see page 16) and has a limited number of smaller retailers with strategies for organic growth who are growing their market share. However, the market is also consolidating and much more rapidly than for example the energy supply market did over a similar time period. This may make entry and expansion more challenging for these smaller entrants and these issues may also force some of the existing smaller players out of the market. Smaller new entrants may also provide an important disruptive challenge to existing incumbents and in a market where there is some evidence from their retail strategies that incumbent in area retailers are more focussed on retention in their own areas in the first instance.

4.4 Proposals

Overall, at this time, limited evidence was found to support a significant change to the allocation of risk in the credit arrangements specifically to support smaller new entrants. Such a change as, at the time of writing, is unlikely to be appropriate as the market had only been open for 12 months and intervention in the credit arrangements specifically to tilt the playing field in the direction of smaller new entrants in this way would be a significant step for which there should be a high bar of evidence that is not currently met. There are already changes happening in the market, for example the Thames time-limited change to the credit requirements[16] and the recent changes established by Severn

[16] See: https://corporate.thameswater.co.uk/Media/News-releases/Thames-Water-supporting-retail-market-entry

Trent[17], UU and Northumbrian Water that will help smaller new entrants. Throughout our review of other sectors no specific examples of credit arrangements that are focussed on supporting new entrants only have been found. However, if the market continues to consolidate and smaller new entrants begin to exit the market this may increase concentration and reduce levels of rivalry.

During the course of our work a number of amendments have been suggested to the credit terms that would improve the arrangements for smaller new entrants. A number of retailers suggested that it would be sensible to offer more unsecured credit based on the payment history of the retailer and some also suggested that the reference to the requirement for a credit rating was not consistent with other commercial negotiations they had entered into elsewhere. Wholesalers generally did not object to the proposal that the credit arrangements and the thresholds for unsecured credit could better reflect the underlying risk of the retailer through the use of credit reports. These reports would define the threshold for unsecured credit and this may better reflect the underlying financial risk (e.g. payment history) of the retailer. This would be open to all but would likely help smaller independent new entrants as they build their payment history and presence in the market where they are already in the market but would not help new entrants to join the market without this history.

Proposal 2: Reflecting payment history: The codes panel could 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. The codes panel, or a sub-group, could engage with credit referencing agencies and seek to establish arrangements where the payment histories of different retailers could be obtained and reflected in the credit scoring reports they provide. Ideally these payment histories would reflect retailer payment performance across all wholesalers in the market. The panel could investigate whether the codes could be amended to ensure that the unsecured credit values available for strong payment histories and otherwise strong financial standing could be based on the values taken from these credit scoring reports. Similar changes have been developed in the energy market and there are relationships between this change and others that are currently going through the code panel.

As has been noted, there is a strong link between credit and the gross margins set under the existing PR16 back-stop price controls. Those controls expire in April 2020 and Ofwat is already considering the appropriate approach to price protection beyond 2020 through its review of the Retail Exit Code.

Proposal 3: Gross margins review: As part of its work to review the appropriate price protection beyond 2020 Ofwat could consider the sufficiency of the gross margins. There were concerns voiced during this study about the gross margins

[17] See for example: https://www.stwater.co.uk/content/dam/stw_businesses/retailer-standards-documents/schedule-3-discount-agreement-castle-signed-22-march-2018.pdf

in the market and whether or not the current default tariffs/price controls adequately include allowances for certain costs and taxes. Undertaking and publishing this analysis would allow appropriate challenge and debate ahead of setting such controls.

5 Are the credit arrangements clear, consistent and working effectively with the rest of the market arrangements and in particular the self-supply regime?

This chapter sets out the key findings from the work in relation to the clarity, consistency and effectiveness of the credit arrangements, including:

- a list of potential examples of poor clarity or issues of inconsistency with the credit requirements and the remaining market arrangements; and
- a list of issues raised in relation to the consistency between the self-supply regime and the credit arrangements.

The overall approach adopted to answer this research question has been limited to:

- understanding the perspectives and arguments of different market participants around potential areas where the arrangements are unclear, inconsistent or not working effectively with the rest of the market arrangements based on the market interviews and workshop; and
- a desk top review of the proposals and change requests brought before the code panel in relation to credit.

Our conclusions and observations in relation to the above research question are limited to the insights and findings from these steps only.

5.1 Potential examples of poor clarity or inconsistency

The table below provides a list of the issues raised either through consultation with market participants or other desk research of potential inconsistencies that might constitute:

- instances where the credit requirements are not clear and different interpretations are possible; and
- instances where the credit requirements are inconsistent or may not work effectively with the rest of the market arrangements.

Figure 14: Potential examples of poor clarity or inconsistency between the credit requirements and other market arrangements

Example	Reference	Description
Credit assessment scores	Wholesale Contract Schedule 1, Part 2: Business Terms 9.13 – Changes in circumstances Schedule 2E of the Business Terms: Unsecured Credit Allowance	• Retailers are entitled to obtain a current credit score and provide evidence of this to the wholesaler and if they hold more than two the lower one should be used and the retailer must notify the wholesaler as soon as practicable if this is downgraded. • There may be ambiguity around the role of wholesalers in challenging or accepting those scores. The codes imply that a score is obtained every 12 months by the retailer but this gives wholesalers' very little certainty of credit scores and leads to long periods during which credit quality can deteriorate significantly. There may be a lack of clarity about the roles and responsibilities of monitoring and reporting credit scores. • Some retailers interpret the codes to be that it is there responsibility to obtain scores and present them to wholesalers and that wholesalers are interfering with this process by credit checking them and obtaining their own credit scores which can result in a deterioration of the retailers credit score. • Wholesalers are concerned that retailers may be cherry picking credit scores to maximise their unsecured credit allowance and not appropriately updating them. They also informed us that in order to manage their risk they monitored all the retailers in their area in any event through credit scoring reports.
Timeline of termination	Wholesale Contract Schedule 1, Part 2: Business Terms Part E: Default and Termination	• If a retailer is a defaulting trading party a wholesaler may give notice to terminate the wholesale contract with an effective date and notify MOSL, Ofwat and WICS as soon as possible. The retailer must notify Ofwat 10 business days prior to the date of termination. • Trading parties have indicated that it is not clear when the notice must be served to the retailer and that the notifications do not follow a linear process. They have 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 that could include some form of interim step ahead of default.
Defaulting trading party &	Wholesale Contract Schedule 1, Part 2: Business Terms	• Wholesalers are able to issue a notice of termination to retailers when they are classed as a defaulting trading party. Retailers can be classed as defaulting trading parties for late payment,

credit in interim supply	Part E: Default and Termination Wholesale Contract CSD 0004 (Interim Supplier Allocation Process) Ofwat interim supply code	persistent failure to pay, failure to provide and maintain credit, persistent late provision of credit support balance or a fundamental breach of the wholesale contract. • Trading parties have set out that this is a ‘nuclear option’ for what is a wide range of actions and that it would be more appropriate to have a more phased series of consequences. • Several market participants also raised concerns that the default processes and procedures had not been tested and were not confident that they would work in practise if they needed to be applied. • Where a retailer goes into administration their customers are then reallocated to other retailers either through an auction via the arrangements of the interim supply code or through the use of a random allocator to other retailers (through CSD 0004) who have opted into the interim supply arrangements. • Were these interim supply arrangements to be used a concern was raised that parties in those arrangements would need to very rapidly obtain credit for the new customers that they receive.
Interest charged on late payment	Wholesale Contract Schedule 1, Part 2: Business Terms 9.9.2 – Default Interest	• Retailers who do not pay their wholesale charges within the specified timescales shall pay interest at the rate of 4% above the bank base rate. Our understanding is that the 4% rate draws from legal precedent. • Smaller independent retailers without a trading history will typically have access to liquid finance at a worse rate than specified in the code and this is shown by the data request information. There was a concern that this also created a weak incentive to pay on time.
Financial resilience testing	Ofwat licensing regime	• As part of the licence application process, new entrant retailers undergo a financial resilience test which focusses on a) whether the applicant has sufficient financial resources to finance its obligations under the law and to deliver its business plan and b) whether it has the capacity to raise new funds in the future. • Some retailers told us that this should be relied upon in the credit arrangements (or it has no value) and others told us that it was unclear what this test entailed. • Some market participants told us that this test should be scrapped as it duplicates a financial assessment that is in effect covered by the credit arrangements in the codes. Others told us that the test should be more robust to stop insufficiently resilient retailers entering the market.

5.2 The self-supply regime and the credit arrangements

Most of the market participants consulted considered that the credit arrangements should be no different for self-supply retailers compared to other retailers. The only issue raised was around the timelines for negotiating credit following the issuing of a self-supply licence.

Figure 15: Potential issues between the credit terms and the arrangements for self-supply retailers

Issue	Reference	Description
Negotiating credit	Self-supply licensing	• Self-supply retailers indicated that, unlike most new entrant retailers, they have an existing number of sites prior to entering the market. Once their licence was granted they were immediately required to post credit for all of their sites. Self-supply retailers are not obliged to switch all of their applicable sites on entry to the market but they indicated that negotiating credit arrangements in this timeline was challenging. They suggested that it would be helpful to revisit the licensing timeline. Ofwat recently published a new application decision document and guidance for self-supply retailers.[18][19]

5.3 Evaluation

The table below considers each of the issues raised and sets out some proposals and the rationale for those proposals, including the potential impacts on effective competition, wholesale financeability, consumer protection and proportionality. Generally the issues highlighted represent areas where the codes or wider market arrangements are not working as effectively as they might and the proposals therefore seek to identify alternative approaches, changes or further work that would improve the clarity, consistency of completeness of the market arrangements.

Overall, there appear to be several areas where the clarity or completeness of the credit arrangements could be improved as well as examples where they could be made more consistent with the rest of the market arrangements.

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[18] Application process for Water Supply and Sewerage Licence limited to self-supply: decision document
[19] Application guidance for Water Supply and Sewerage Licence (WSSL) limited to self-supply

Figure 16: Proposals for clarity, consistency and completeness

<table>
<tr><th>Example/Issue</th><th>Proposals and rationale</th></tr>
<tr><td>Credit assessment scores</td><td>The code panel could develop and consider a change proposal to the codes that makes clear that:
Credit reports could be provided more regularly than once every 12 months, perhaps every quarter;
Wholesalers must accept the findings of those credit reports where they comes from one of the credit referencing agencies listed rather than challenging those reports and where they are being provided more frequently there should be less need for them to be requested by wholesalers also;
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 this doesn’t result in a deterioration of retailers credit score.
Generally, as per the codes it is the retailers responsibility to provide the credit reports but the code panel could discuss with a credit referencing agency (or group of agencies) whether such reports could be provided independently by the agency to the pool of market participants as and when they are required. This could potentially provide both an independent monitoring party and also an administrative saving to retailers, especially where multiple wholesalers and retailers may be requesting multiple similar reports from the same agencies. Such an arrangement would need to ensure that the requesting of reports did not result in any deterioration in the credit score for retailers.</td></tr>
<tr><td>Timeline of termination</td><td rowspan="2">Ofwat, the code panel and market participants could take forward some work to test the default, termination and supplier of last resort arrangements in the codes. This might involve holding workshops with market participants to clarify the code arrangements in these areas and to test how these arrangements would work in practise.
Any inconsistency in timings arising from this exercise or suggestions to create a staged default process could then be taken forward through the code panel as potential amendments to the codes.</td></tr>
<tr><td>Defaulting trading party and credit in interim supply</td></tr>
<tr><td>Interest charged on late payment</td><td>Where trading parties consider that the arrangements in this area should be changed, they could bring a code change to the panel for the panel to consider. As per the normal arrangements for amendments.</td></tr>
<tr><td>Financial resilience testing</td><td>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. The test should ensure that a new entrant retailer can meet the requirements of the credit terms.</td></tr>
</table>

In the table below we set out a single proposal for self-supply that should improve the effectiveness of that regime and the proportionality of the arrangements without impacting on wholesaler financeability or consumer protection. The issue highlighted represents an area where the wider market arrangements are not working as effectively as they might and the proposal therefore seeks to identify a change that would improve the clarity, consistency of completeness of the market arrangements.

Figure 17: Proposals for self-supply

Example/Issue	Proposal and rationale
Negotiating credit	• 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.

6 How could the credit arrangements be improved to increase benefits to customers from the Non-Household (NHH) retail market?

During the course of the review consultees that were interviewed and workshop participants were asked a broader open question around how the credit arrangements could be improved to increase the benefits to customers of the market. The purpose of this question was to capture broader suggestions around potential improvements to the credit arrangements.

A number of different proposals were highlighted for potential changes to the credit arrangements currently prescribed in the codes that go beyond the recommendations raised in previous sections of this report. This chapter provides:

- a description of potential example improvements to the code; and
- a qualitative assessment of those examples against each of the four aspects of the framework to describe whether they are likely to deliver an overall improvement.

The overall approach adopted to answer this research question has been limited to:

- identifying the proposals for future improvements to the credit arrangements based on the market interviews and workshop; and
- a qualitative assessment of the different options against the assessment framework.

Our conclusions and observations in relation to the above research question are limited to the insights and findings from these steps only.

6.1 Potential improvements to the credit arrangements

A range of potential improvements were suggested to the credit terms either through the consultations with stakeholders or our desk research.

- **Unsecured credit for all retailers:** These proposals would deliver an increase in the level of unsecured credit available to all retailers, similar to the arrangements recently developed by Thames Water[20]. This would be set up to a threshold which could be based on the level of risk which is deemed to have a low impact on a wholesaler's financeability. There are two ways this recommendation could be taken forward:

[20] See: https://corporate.thameswater.co.uk/Media/News-releases/Thames-Water-supporting-retail-market-entry

- **Opt in:** The new arrangements would not be prescribed into the codes. Instead wholesalers would be able to opt in and determine their own levels of risk appetite.
- **Prescribed:** Prescribe a level of unsecured credit for each wholesaler and have this written into the codes.

- **Pooled credit**: Introduce a pooled credit scheme where all retailers are covered by a single financial instrument. This would likely require a central monitoring and reporting body to work with the financial institution and set up the new arrangements. The ATOL scheme in the travel sector represents one such model[21]. The key benefits would be the economies of scale of such a scheme which would reduce the cost of credit and the level of administration for retailers and wholesalers as they would be interacting with a central body once rather than through many bi-laterals. Where this arrangement was taken up by several parties it could potentially reduce costs for retailers and even increase coverage for wholesalers. This arrangement could be developed in a number of ways:
  - **Opt in:** Make the scheme opt in. Setting up a scheme would require a minimum number of trading parties and an 'opt in' arrangement would allow parties to join the scheme only if they wished to.
  - **Prescribed**: Prescribe the scheme for the entire industry in the codes. This would effectively involve removing the other options from the codes and requiring all credit cover to be provided through this regime.
- **Wholesale risk sharing mechanism:** A wholesale risk sharing mechanism would involve providing a mechanism that would allow the risk of retailer default to be shared between wholesalers, retailers and customers. 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. Such an arrangement would, most likely, push more of the risk of retailer default onto customers through wholesale charges. A wholesale risk sharing mechanism was considered in detail by Ofwat in its initial consultation on credit terms and rejected in its final decision document[22].

Any change would only represent a benefit to the current arrangements if they resulted in an overall improvement to one or all of the following:

- Levels of competition and rivalry in the retail market;
- Wholesaler financeability;

[21] See: http://www.caa.co.uk/ATOL-protection/Consumers/About-ATOL/
[22] A detailed approach to developing a wholesale risk sharing mechanism was defined by Ofwat in its initial consultation on credit terms, see: https://www.ofwat.gov.uk/wp-content/uploads/2016/06/pap_con20160609rmocreditapp4.pdf

- Consumer protection; or
- Proportionality in the arrangements and regulatory burdens.

6.2 Evaluation

The table below sets out each of the proposed improvements raised to the market arrangements and provides an assessment of those arrangements against each of the four elements of the framework.

Solution	Promote effective competition	Protection for customers	Wholesaler financeability	Proportionate regulation	Additional Comments
1a. Increase unsecured credit for all retailers (opt in).					• Reduces entry barriers with corresponding impact on competition but opt-in reduces impact relative to 1b. • Increases wholesale exposure by reducing credit cover but only where the benefits from diversified default risk are immaterial. • May lead to greater risk of customer impacts from default again where benefits from diversified default risk are immaterial. • Lowers regulatory burdens through increasing unsecured credit availability and an opt-in model.
1b. Increase unsecured credit for all retailers (prescribed).					• Reduces entry barriers with corresponding impact on competition. • Increases wholesale exposure by reducing credit cover but only where the benefits from diversified default risk are immaterial. • May lead to greater risk of customer impacts from default again where benefits from diversified default risk are immaterial. • Potentially lowers regulatory burdens by increasing unsecured credit but depends on implementation of arrangements.
2a. Pooled credit (opt in)					• Any pooled arrangement may need to be prescribed as firms with a better credit standing may be able to access credit at lower cost than the pool making the arrangement ineffective.
2b. Pooled credit (prescribed)					• Potential benefits to all areas of the framework. • Prescribed arrangements would maximise coverage and any efficiencies from arrangement versus alternatives but could increase the regularity of default putting more pressure on supplier of last resort arrangements.
3. Wholesale risk sharing mechanism					• Significant reduction in entry barriers with corresponding impact on competition. • Would improve wholesaler financeability if greater exposure could be recovered through wholesale charges. • Limited impacts on proportionality, arrangements could be more efficient overall given wholesale cost of capital but would also require the creation of significant new regulatory regime. • Significant negative impacts to consumer protection as customers would pay for retailer default in full in wholesale charges.

Overall the qualitative assessment suggests that the introduction of an increase in the unsecured credit arrangements could reduce entry barriers by lowering credit costs with a potential corresponding impact on competition and levels of rivalry. However, the introduction of such a mechanism could increase wholesale exposure by reducing the level of credit cover provided to the wholesaler with corresponding risks to the customer if the wholesaler needed to take recourse to the re-open their price limits in the event that default was material. Wholesalers could benefit from a more diverse group of retailers that purchase their wholesaler services, in the event of default the impact on wholesalers would be lower where their risk is not concentrated in a single retailer. An increase in unsecured credit allowances could support that diversification of retailers in their appointed areas and hence wholesale risk would only increase where the benefit of diversification was offset by a reduction in credit cover. Overall, the approach is likely to lower regulatory burdens by reducing the level of credit needed, particularly for smaller agreements. During the course of this work a variety of new wholesalers have established similar arrangements to the Thames model and these arrangements now cover c.39% of the supply points in market[23]. This may suggest that an opt-in model is appropriate but could be reconsidered if the new arrangements were removed in the future by wholesalers.

The pooled credit option is already being developed further by an existing market participant. A pooled credit model would represent a fundamental shift in the form and nature of the credit arrangements and there would most likely be significant transitional costs associated with moving away from the current model to any alternative. It may therefore only be appropriate to consider such a change after full consultation with trading parties, including explicit consideration of any transitional costs and perhaps involving a transitional period. However, based on the qualitative evaluation such a model does offer the potential for a 'win win' change that could potentially both reduce retail credit costs and also reduce wholesale risk exposure. The pooled credit option could therefore be explored further by the code panel as this option 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. A prescribed model is likely to be required as firms with a better credit standing may be able to access credit at lower cost than the pool making the arrangement ineffective.

A move to a pooled credit model would represent a material change to the credit arrangements in the codes at a very early stage in the development of the market and could change the overall balance of risk. If the code panel is able to develop an arrangement that it considers holds merit then it would seem sensible that this is consulted on more broadly by Ofwat.

[23] Proposals have been implemented by Thames Water (512,556 supply points), Northumbrian Water (176,321 supply points) and Severn Trent Water (403,520) who collectively cover around 39% of the market. Supply point data taken from MOSL 2nd April 2018.

A wholesale risk sharing mechanism was considered by Ofwat in the original consultation. Such a mechanism could offer a significant reduction in entry barriers by reducing the credit cost for retailers with a potential corresponding impact on levels of entry and rivalry in the market. It could also improve wholesaler financeability if greater exposure could be recovered through wholesale charges. There would be limited impacts on proportionality and regulatory burdens but the mechanism would need to be created and administered and such an arrangement could be more efficient overall given that the wholesale cost of capital is likely to be significantly lower than that of a retailer. The arrangement could result in significant negative impacts to consumer protection as customers would pay for this risk in their wholesale charges.

7 Overall conclusions and next steps

At the time of writing, the Non-Household water retail market had been open for just 12 months and the credit arrangements were established less than a year ago following significant consultation. Given the infancy of the new market there may be a strong need for regulatory certainty and correspondingly there should therefore be a high evidential bar for material changes to the credit arrangements at this time.

Overall limited evidence has been found that would suggest that material changes to the credit arrangements and the balance of risk set out in them are required. Smaller new entrants have raised significant concerns throughout the course of the review but a material shift in the balance of risk cannot be justified at this time, as other changes in the market could help to alleviate these concerns and they may be more adequately addressed as part of any resetting of the existing 'default tariff' price caps post April 2020.

Nevertheless a number of changes to drafting, process or interpretation have been identified that would improve the clarity, consistency or effectiveness of the credit arrangements and should be taken forward at the earliest opportunity.

In considering how arrangements should be taken forward market participants told us that the code panel exists to consider and deliver changes to the codes and should be used as the vehicle for changes in the first instance. However, where changes were material or significantly altered the allocation of risk, many market participants considered that this should be consulted on formally by Ofwat as a material change to the market arrangements.

Figure 18: Proposals to improve the credit arrangements, owners and timescales

Proposals	Owner	Priority	Timescale
Proposals to support a level playing field on credit arrangements			
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. These arrangements could be published in a standard format by MOSL so that there is full transparency, including over the costs of such arrangements. The code panel could 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 and for MOSL to publish all of these arrangements on their website in a common location. Maintaining visibility of these arrangements could help to ensure that trading parties are not in breach of their obligations whilst retaining the opportunity for innovation in the credit arrangements under schedule 3. It may also increase market confidence around the use of PCGs and the existence of a level playing field in relation to them.	Code panel	High	ASAP
Proposals relating to smaller new entrants			
2. Reflecting payment history- The codes panel could 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. The codes panel, or a sub-group, could engage with credit referencing agencies and seek to establish arrangements where the payment histories of different retailers could be obtained and reflected in the credit scoring reports they provide. Ideally these payment histories would reflect retailer payment performance across all wholesalers in the market. The panel could investigate whether the codes could be amended to ensure that the unsecured credit values available for strong payment histories and otherwise strong financial standing could be based on the values taken from these credit scoring reports. Similar changes have been developed in the energy market. Similar changes have been developed in the energy market and there are relationships between this change and others that are currently going through the code panel.	Code panel	High	ASAP

3. Gross margins review- As part of its work to review the appropriate price protection beyond 2020 Ofwat could consider the sufficiency of the gross margins. There were concerns voiced during this study about the gross margins in the market and whether or not the current default tariffs/price controls adequately include allowances for certain costs and taxes. Undertaking and publishing this analysis would allow appropriate challenge and debate ahead of setting such controls.	Ofwat	High	Before January 2019
Proposals to improve clarity consistency or effectiveness of arrangements			
4. Credit assessment scores- The code 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 this doesn't result in a deterioration of retailers credit score. Generally, as per the codes it is the retailers responsibility to provide the credit reports but the code panel could discuss with a credit referencing agency (or group of agencies) whether such reports could be provided independently by the agency to the pool of market participants as and when they are required. This could potentially provide both an independent monitoring party and also an administrative saving to retailers, especially where multiple wholesalers and retailers may be requesting multiple similar reports from the same agencies. Such an arrangement would need to ensure that the requesting of reports did not result in any deterioration in the credit score for retailers.	Code panel	High	ASAP
5. Termination, default and interim supply- Ofwat, the code panel and market participants could take forward some work to test the default, termination and supplier of last resort arrangements in the codes. This might involve holding workshops with market participants to clarify the code arrangements in these areas and to test how these arrangements would work in practise. Any inconsistency in timings arising from this exercise or suggestions to create a staged default process could then be taken forward through the code panel as potential amendments to the codes.	Ofwat, code panel &	High	ASAP

	trading parties		
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.	Ofwat	Low	ASAP
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. 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.	Ofwat	Medium	ASAP
Proposals for broader long-term improvements			
8. Pooled credit models- the pooled credit option should be explored further by the code panel as this option offers the opportunity to deliver significant benefits. If the code panel is able to develop an arrangement that it considers holds merit then we would recommend that this is consulted on more broadly by Ofwat.	Code panel & Ofwat	Low	ASAP

A. Stakeholders consulted

List of stakeholders consulted

Below is a list of the stakeholders consulted throughout the course of the study. The aide memoire used to guide these discussion is provided overleaf.

Company	Category	Consultees
Greene King	New entrant: self-supply	Gavin Worthington
Waterscan	New entrant: retailer (self-supply)	Neil Pendle
Advanced Demand Side Management (ADSM)	New entrant: retailer	Patrick McCart
The Water Retail Company	New entrant: retailer	Jacob Tompkins
Everflow	New entrant: retailer	Josh Gill, James Cleave
Castle	Initial in area retailer	Richard Moore and John Reynolds
Anglian Water Business	Initial in area retailer	Wendy Monk
Waterplus	Initial in area retailer	Jonas Reed
Southern Water	Wholesaler	Dylan Freeman, Mathew Labrum, Ashley Marshman
Thames Water	Wholesaler	Julian Tranter, Mark Holloway
Market Operator Services Limited (MOSL)	Market Operator	Adam Richardson

Aide memoire for semi-structured interviews

1. What credit arrangements are currently being used and which are not? What factors are driving this selection?
2. Has this changed since market opening - what has driven any shift?
3. What is the expectation of how credit arrangements usage may change over next few years?
4. Are the credit arrangements appropriate for smaller new entrants? Does the market need to do more to support smaller new entrants? If so what options may be appropriate and how would we define a ‘smaller’ new entrant that needs support?
5. Do you consider that the credit arrangements are a material barrier to entry?
6. Are the credit arrangements the most significant barrier to entry? Are there other barriers?
7. How are the credit arrangements working in practice? Is there an expectation gap between design and practice? Which credit arrangements are working as expected and which are not? Is there ambiguity/further clarity needed in codes?
8. Are the credit arrangements, on the whole, appropriate for a market with these characteristics?
9. Are there any other issues with the current credit arrangements?
10. How could the current credit arrangements be improved? Do they require an evolutionary (minor) change or a more fundamental restructure?
11. How should changes to the credit arrangements be taken forward? Should recommendations be made to the industry/Panel for discussion and development or should changes be driven by Ofwat?