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## Wholesale Retail Code Change Proposal – Ref CPW048

<b>Modification proposal</b>	Wholesale Retail Code Change Proposal CPW048 – Alternative Payment Terms
<b>Decision</b>	Ofwat has decided to approve this change proposal
<b>Publication date</b>	19 December 2018
<b>Implementation date</b>	31 January 2019

### Background

The Business Terms provide two payment terms options, Pre-Payment and Post-Payment, for the payment of Primary Charges from Retailers to Wholesalers.

The Pre-Payment option requires a Retailer to make the payment of Primary Charges before the invoice period (based on the P1 Settlement Run).

The Post-Payment option enables Retailers, with access to appropriate credit arrangements, to pay Primary Charges after the R1 Settlement Run. In order to access Post-Payment terms, the Retailer must provide one or more forms of Eligible Credit Support and/or (with the agreement of the Wholesaler) Alternative Eligible Credit Support to meet the Credit Support Amount<sup>1</sup>.

The various types of Eligible Credit Support are detailed in section 9.11.4 of the Business Terms and include:

- Cash Security Account;
- Guarantee;
- Letter of Credit; and
- A Surety Bond.

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<sup>1</sup> The Credit Support Amount is the amount expressed in pounds sterling to be provided by the Contracting Retailer calculated on a monthly basis in accordance with Section 9.11.3 of the Business Terms (representing the Credit Support Requirement less any applicable Unsecured Credit Allowance and any interest accrued on the cash deposited in the Cash Security Account for that Contracting Retailer)

Trading Parties are free to agree to use one, or a combination, of the different types of Eligible Credit Support to meet the Credit Support Amount. Trading Parties can also agree Alternative Eligible Credit Support (section 9.11.5 of the Business Terms).

## **The issue**

Pre-Payment is the only option available for Retailers that are unable to access the credit support necessary to qualify for Post-Payment. Pre-Payment Terms mitigate a cashflow risk for Wholesalers although the Proposer, Yorkshire Water Business Services, has highlighted that Retailers do not share this benefit.

The Post-Payment option is restricted in its availability in that a Retailer must provide the Credit Support Amount by one or more forms of Eligible Credit Support and/or Alternative Eligible Credit Support. The Credit Support Amount provides Wholesalers with protection in the event of a Retailer default. Post-Payment Terms provide more positive cashflow for Retailers than Pre-Payment.

The Proposer considers that the two types of payment terms are rigid and may create barriers to entry due to the financing requirements for Pre-Payment and the necessity to have built a credit history to meet the Credit Support Amount necessary to access Post-Payment terms. In addition, the Proposer considers that the Pre-Payment and Post-Payment options can inhibit a Retailer's ability to innovate and offer customers flexible terms of payment.

## **The modification proposal<sup>2</sup>**

It is proposed that a third, more flexible, payment terms option is added into the Business Terms, this being "Alternative Payment Terms". Whilst a Wholesaler will not be obliged to offer Alternative Payment Terms, it is proposed that a Wholesaler shall be obliged to give 'due and proper consideration' to proposals for Alternative Payment Terms. Both parties shall also be obliged to act reasonably towards one another without unreasonable delay and to negotiate in good faith with each other.

Where the Alternative Payment Terms involve Post-Payment for some or all of the Primary Charges, these must be accompanied by an appropriate Alternative Eligible Credit Support. Where Alternative Eligible Credit Support is provided, this must be in

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<sup>2</sup> The proposal and accompanying documentation is available on the MOSL website at <https://www.mosl.co.uk/market-codes/change#scroll-track-a-change>

accordance with Schedule 3 of the Business Terms which provides the Key Terms for Alternative Eligible Credit Support.

It is proposed that Schedule 3A is introduced into the Business Terms to provide Key Terms for Alternative Payment Terms. These include that Alternative Payment Terms shall be:

1. in respect of the Primary Charges;
2. compatible with the Market Settlement Process and timetable and specific about the payment terms related to subsequent reconciliation invoices resulting from the Market Settlement Process;
3. negotiated and agreed between the Parties;
4. fully documented as a Schedule 3A Alternative Payment Terms agreement;
5. supported by a valid Schedule 3 Alternative Eligible Credit Support arrangement agreed between the Parties that describes the mechanism for determining any adjustment to the Credit Support Amount required to provide the necessary level of credit support associated with the Alternative Payment Terms;
6. specific about the terms and conditions for returning to standard Pre-Payment or Post-Payment arrangements;
7. subject to an obligation on the Contracting Wholesaler to publish in full, all the terms of any Alternative Payment Terms agreement along with its accompanying Schedule 3 Alternative Eligible Credit Support agreement in a prominent place, relevant to the Competitive Market, on its website including the identity of the Contracting Retailer within five Business Days of entering into such agreement; and
8. any redactions, which should be clearly marked, may only apply to personal data the disclosure of which would breach the Data Protection Act 2018 or any subsequent or equivalent Law.

## **Industry consultation and assessment**

The Proposer presented the Change Proposal to the User Forum on 18 October 2018. The Proposer discussed the impact of the proposed changes and highlighted the expected benefits.

A Request for Information on the draft change proposal commenced on 25 October 2018 and concluded on 8 November 2018. In total, there were 23 respondents, 13 Wholesalers and ten Retailers.

Responses to the Request for Information were mixed. Ten respondents agreed with the proposed change. Those who supported the proposed change considered that it

offers flexibility and has benefits for the end customer. The Proposer noted that many of the respondents who were not in support of the proposed change were in support of the principle of introducing flexibility to payment terms.

Key points raised in response to the consultation are discussed further below. A more detailed overview of the consultation responses can be found on the [Market Operators website](#).

## **Unfair advantage for associated Retailers**

One Wholesaler and two Retailers highlighted concerns that associated Retailers may have an unfair advantage in agreeing Alternative Payment Terms. These respondents expressed concerns that the change would not result in a level playing field for all Retailers to agree Alternative Payment Terms.

A Retailer respondent was in favour of flexibility in payment terms but argued that Alternative Payment Terms should be offered to all Retailers based on the individual Retailers' credit worthiness by reference to credit scores and payment history. It suggested that the advantages gained by associated Retailers through the use of Parent Company Guarantees (PCG) should be addressed. In the absence of addressing these concerns, the respondent argued that this Change Proposal will mostly favour associated Retailers. This respondent considered that the use of PCGs provides associated Retailers with an unfair advantage over non-associated retailer competitors because the beneficiary and the Guarantor are either the same entity or are in the same group. It considers that it is by using a PCG that Wholesalers are able to offer even greater credit terms to associated Retailers on an effectively unsecured basis. It highlighted that associated Retailers can offer extended credit terms to customers of up to six months in arrears, which independent Retailers would be unable to fund.

The Proposer noted the concerns that associated Retailers could have an unfair advantage in negotiating Alternative Payment Terms. It suggested that there is a general perception that associated Retailers benefit from flexibility in payment terms. However, the Proposer considers that the required transparency around Alternative Payment Terms would remove the perceived concern. It would be open to all Retailers to propose equivalent Alternative Payment Terms to those a Wholesaler may agree with an associated Retailer. A Wholesaler would need to justify any perceived discriminatory treatment of another Retailer. The Proposer therefore considered that the change would promote a level playing field approach. In addition to the above, one Retailer respondent suggested that if all or most Wholesalers were to offer Alternative Payment Terms, the risks of an unfair advantage to associated Retailers would be mitigated.

A Retailer argued that there would be an additional regulatory complexity should the Change Proposal be approved. It argued that it will be difficult to ensure that Alternative Payment Terms are offered fairly to all Retailers. However, the requirement for the publication of the Alternative Payment Terms provides the required level of transparency and opportunity for discriminatory behaviour to be identified.

## **Barriers to entry**

It was suggested by two respondents that the proposed change could increase barriers to entry. One Retailer respondent highlighted that new entrant Retailers will be in a weaker bargaining position. It was considered by another respondent that the proposed change will increase barriers to entry for Retailers who are not of investment grade level. Another respondent suggested that if the proposal is not amended to address the unfair advantage associated Retailers have through the use of PCGs, the proposal could create barriers to entry for non-associated Retailers as their ability to compete on a level playing field would be diminished further.

The Proposer considered that the change will reduce barriers to entry and promote transparency, ensure comparability and hence consistency, and promote the level playing field approach. Ten respondents to the Request for Information (four wholesalers and six Retailers) also considered that the proposed change will assist in reducing barriers to entry. Those supportive of the proposal argued that the change promotes flexibility, by allowing new entrants to negotiate payment terms which suit their business models, which will enable them to contribute to the competitive market.

## **Implementation and ongoing operational costs**

There was a mixed response to the question seeking information regarding the implementation and ongoing operational costs for Trading Parties.

Retailer respondents considered that the implementation and ongoing operational costs would be low to minimal. One Retailer respondent highlighted that the proposed change would reduce its working capital requirement by 1.5 months. The proposed change will result in very low implementation costs to the Market Operator, with these costs relating to the publication of Alternative Payment Terms agreements on its website and maintenance of the data. There will be no changes required to the Central Market Operating System (CMOS) and therefore no CMOS costs will be incurred.

A number of Wholesaler respondents forecast implementation and ongoing operational costs may be significant. Wholesalers indicated that they would need to

update their systems to accommodate the ability to handle Alternative Payment Terms. Wholesaler respondents estimate that the ongoing operational costs will be significant. Reasons for this included:

- management of credit arrangements;
- negotiation of contracts;
- additional resources to facilitate new payment terms;
- additional requirements for banking, allocation and reporting; and
- increased resources to manage and monitor operational work.

The implementation and ongoing operational costs are likely to vary depending on the type of Alternative Payment Terms the Trading Parties agree. The Proposer acknowledged that there is potential for significant costs to be incurred if the Change Proposal is approved and Alternative Payment Terms are agreed. However, Trading Parties will not be obligated to agree complex payment terms which will result in significant costs.

### **Increased risk to Wholesalers**

Eight Wholesaler respondents expressed concern that the proposed change increases Wholesaler exposure to risk. Some highlighted that Retailers may request Alternative Payment Terms beyond the current Post-Payment terms which could negatively impact Wholesaler cashflow. The Proposer has acknowledged that there could be a negative impact on Wholesaler cashflow if it were to agree to Alternative Payment Terms which have a negative cashflow impact. The Proposer highlighted that there is no compulsion for Wholesalers to agree to Alternative Payment Terms which would have a material negative impact on cashflow. In addition, it suggested that there is no indication that Retailers would necessarily request such terms.

Four Wholesalers expressed concern regarding the impact of the proposal on Wholesaler working capital. It was highlighted that business plans for PR19 have been submitted although the impact of the proposed change on working capital has not been factored in. The Proposer has highlighted that the impact on working capital will be dependent on the Alternative Payment Terms agreed by Trading Parties. Wholesalers must give 'due and proposer consideration' to Alternative Payment Terms proposals, this is not an obligation to agree to them where it considers that working capital will be disproportionately affected, although noting there should be no discrimination in favour of one class of Retailer. It also highlighted that Trading Parties could use Alternative Payment Terms to agree incremental change from Pre-Payment to Post-Payment terms which could assist in easing working capital demands.

The Proposer has acknowledged that the Change Proposal may enable Trading Parties to agree Alternative Payment Terms which have greater inherent risk. However, it reiterated that this risk would only occur if the Wholesaler and the Retailer were to agree. One of the Wholesaler respondents that considered the proposal increases the Wholesaler exposure to risk also highlighted that Alternative Eligible Credit Support can go some way to mitigating this increased risk.

## **Complexity and transparency**

A number of Wholesaler respondents suggested that the proposed change adds complexity to the market and were unable to identify Wholesaler benefit from the proposed change. It was highlighted that there are already options available to improve working capital through use of Alternative Eligible Credit Arrangements and that the current payment terms provide consistency which enables administrative simplicity and efficiency. It was suggested that Retailers may experience difficulties in operating and navigating around contracts with different Wholesalers as some may be on standard payment terms and others may be Alternative Payment Terms. In addition, one respondent considered that Wholesalers would have an additional complex administrative burden of essentially pricing default and interest rate risk.

The Proposer responded to concerns regarding introducing complexity to confirm that the proposed change introduces the opportunity to agree Alternative Payment Terms only, it does not add complexity in and of itself. The level of complexity of the Alternative Payment Terms would depend on the nature of the agreement between the Wholesaler and the Retailer. The Proposer also highlighted that the majority of respondents to the Request for Information were in favour of the principle of introducing flexibility to payment terms.

A Wholesaler considers that the proposed change decreases the transparency of the Market Terms, as there is a lack of clarity around Alternative Payment Terms. However, the proposal includes an obligation that Wholesalers must publish Alternative Payment Terms. This provides the transparency to other Trading Parties concerning the various types of Alternative Payment Terms which are being agreed between Retailers and Wholesalers.

## **Panel recommendation**

The Panel considered this Change Proposal at its meeting on 27 November 2018 and recommended CPW048 to the Authority for rejection.

Eight Panel Members agreed with the proposed solution, those in support of the Change Proposal agreed with the Proposer that it will allow greater innovation and flexibility in the market.

Three Panel Members disagreed with the proposed solution. Those who did not agree considered that associated Retailers would receive preferential treatment and that this could create barriers to entry. It was also considered that the proposed change would introduce working capital risks for Wholesalers and add administrative burden. One Panel Member abstained from voting on this Change Proposal.

## **Our decision**

We have considered the issues raised by the modification proposal and the supporting documentation provided in the Panel's Final Report. We have also fully considered the views of the Panel Members who did not vote in favour of approving this Change Proposal.

We have concluded that implementation of CPW048 will better facilitate the principles and objectives of the Wholesale Retail Code detailed in Schedule 1 Part 1 Objectives, Principles and Definitions and is consistent with our statutory duties. We note that the Panel recommended, in the event that the Authority were to approve this Change Proposal, implementation for 29 March 2019. We consider that this presents an unnecessarily long time for implementation of this Change Proposal. We consider that the flexibility that this Change Proposal introduces brings benefits to the market and to Customers and therefore we think that the implementation date should be sooner. We have therefore decided that this Change Proposal be implemented on 31 January 2019.

## **Reasons for our decision**

We have set out below our views on which of the applicable code principles are better facilitated by the modification proposal.

### **Barriers to entry**

This code modification provides an additional and more flexible option for payment terms for both existing and new entrants into the market. It enables Trading Parties to negotiate bespoke payment terms where it would be commercially preferable to deviate from the current Pre-Payment and Post-Payment terms options. We consider that the proposed change furthers the principle of reducing barriers to entry for these and the further reasons outlined below.

It is normal commercial practice for businesses to be able to agree payment terms. However, the market codes provide no alternative to the two current payment terms options available to Trading Parties. The introduction of flexibility to negotiate Alternative Payment Terms may be more favourable to a prospective new entrant business than the current payment terms options. This in turn may assist in encouraging new entrant Retailers to engage with and enter the market.

We note the concerns raised that associated Retailers will benefit as they are able to use PCGs to satisfy the Credit Support Requirement. It has been suggested that PCGs offer an unfair advantage to this class of Retailer and may increase barriers to entry. This perceived concern is a wider issue that does not only impact the proposed change. It is feasible that a Wholesaler may be more likely to offer flexible terms to an associated or more established Retailer, because they are more credit worthy or because there may be general economies of scale. However, it is not clear to us from the evidence provided that the proposed change will create real barriers to entry. And the flexibility for Retailers to negotiate in good faith bespoke terms better suited to their business models arguably removes barriers.

The wider issue of considering any perceived unfair advantage which can be gained by an associated Retailer using a PCG is currently being considered by the Credit Committee.

But, to be clear, we do not consider it would be efficient and reflective of a genuine market environment if every Retailer were to face the same costs regardless of the costs it itself imposed on the system (for instance, through credit risk) – rather, we want to ensure that the framework is such that retailers are able to bring innovative offerings or choice which customers value and are able to take advantage of if they choose to.

It is also important to note here that Ofwat has enforcement powers, including those under the Competition Act 1998, to take action against Trading Parties should anti-competitive behaviour be identified. We expect Wholesalers to adhere to the obligation to give ‘due and proper consideration’ to proposals for Alternative Payment Terms and not to show any undue preference to a particular class of Retailer.

The Change Proposal includes an obligation that a Wholesaler gives ‘due and proper consideration’ to proposals for Alternative Payment Terms, and we expect that this would likely include proposals received from new entrant Retailers. When proposing and considering Alternative Payment Terms, Trading Parties are also obligated act reasonably to one another and to negotiate in good faith and in accordance with the principles of Non-Discrimination and No Barriers to Entry.

We consider that the requirement to publish Alternative Payment Terms which have been agreed offers the transparency needed to reduce concerns that the change could increase barriers to entry. New entrant Retailers will be able to view Alternative Payment Terms which have previously been agreed and may be in a position to propose and subsequently agree identical or similar terms to suit its business and commercial needs. As such, we consider that publication of Alternative Payment Terms has potential to encourage market entry by removing the restriction that only Pre-Payment or Post-Payment terms can be agreed.

### **Customer participation**

Introducing Alternative Payment Terms may bring benefits for Non-Household Customers. Successful agreement of Alternative Payment Terms may result in working capital and cashflow benefits for Retailers, which in turn could enable Retailers to innovate their price and service offerings and offer more flexible payment terms to Non-Household Customers. There may be benefits to competition which could be gained by the introduction of Alternative Payment Terms, inclusive of the potential for increased switching if Retailers are able to offer more flexible payment terms.

### **Proportionality**

It is apparent from the responses to the Request for Information that many Retailers and Wholesalers are in support of the principle that flexibility in payment terms would be advantageous. We consider that the proposed approach provides a proportionate solution to offer flexibility to Trading Parties where they wish to pursue that option which will assist in addressing the concerns that the current payment terms are lacking in this regard.

We note that concerns were raised that the proposed change will increase Wholesaler risk and administrative burden. We consider that, as there is not an obligation for Wholesalers to accept proposed Alternative Payment Terms, Wholesalers will maintain control over their assessment and assumption of risk in this context. The obligation on the Wholesaler is to give 'due and proper consideration' to proposals. This accounts for the fact that there may be legitimate commercial or other reasons for the refusal to agree, notwithstanding that Wholesalers must ensure that they are not acting in a discriminatory or anti-competitive manner. Whilst we acknowledge Wholesaler concerns that there may be an additional administrative burden in assessing proposals, inclusive of risks, we consider this is proportionate as it is balanced by the potential benefits the proposed change could bring to the market. In particular, the potential for Non-Household Customers to be able to agree more flexible payment arrangements with Retailers

which in turn could contribute to more dynamic and effective competition and may have a positive impact on engagement with the market.

Some Trading Parties requested that the proposed change included further clarity as to what Alternative Payment Terms are and some suggested different types of Alternative Payment Terms which could be incorporated into the code. We do not agree with these views. Further definition would, in our view, act in conflict with the primary purpose of this change proposal which is to simply offer the option for alternative payment terms and would reduce the level of flexibility available to Trading Parties to agree bespoke and innovative terms. The Key Terms provided in the proposed Schedule 3A of the Business Terms provides restrictions as to what Trading Parties are able to agree to provide minimum protections. For example, the agreement must be supported by valid Alternative Eligible Credit Support and be compatible with the Settlement Process or timetable.

We note that concern was expressed that the proposed change increases complexity for Retailers in relation to the variety of different payment terms they have agreed with different Wholesalers. However, it would be a commercial decision for individual Retailers to make regarding the number and variety of Alternative Payment Terms it intended to propose to or agree with each Wholesaler. Whilst the current payment terms offer simplicity, the development of Alternative Payment Terms would be by way of agreement between a Wholesaler and Retailer, and it is not necessarily the case that these be complex.

Some Wholesalers estimate that the implementation and ongoing operational costs will be significant. However, to reiterate the above, there is no obligation to accept Alternative Payment Terms proposals. The impact on systems or other ongoing costs will be as a result of what a Wholesaler decides to agree with a Retailer and these costs therefore remain within the control of the Wholesaler. It would not be obliged to accept Alternative Payment Terms which would have a material negative impact.

We also note that the proposal does not impose changes to CMOS.

## **Transparency**

Requiring publication of Alternative Payment Terms which have been agreed between Wholesalers and Retailers furthers the principle of transparency. This provides a method of ensuring agreements between Wholesalers and Retailers are visible to other Retailers who may be considering requesting flexible terms from the relevant Wholesaler.

## **Decision notice**

In accordance with paragraph 7.2.8 of the Market Arrangements Code, Ofwat approves this change proposal.