Centre City Tower, 7 Hill Street, Birmingham B5 4UA
21 Bloomsbury Street, London WC1B 3HF

Sent by email to wholesalers and their associated retailers

24 September 2018

Dear market participant

Advisory letter and request for response

This letter has several purposes:

a) It informs you of our potential concerns about possible breaches of competition law;[1] on the part of both wholesalers and associated retailers; and
b) It highlights what you can do to ensure that you comply with competition law in future.

You should:

a) Acknowledge receipt of this letter within 10 days of receipt; and
b) Confirm any action you intend to take to address any issues arising within 30 days of the date of this letter, which should be completed by no later than the end of January 2019.

As you will be aware, in December 2017, we announced an initial review ("the review") of the credit arrangements in the business retail market. The review aimed to establish whether the current arrangements create undue and unfair barriers to entry. We were particularly concerned to understand how the current arrangements affected smaller new entrants.

We published the conclusions of the review in June 2018, alongside which we set out our view and next steps on the credit arrangements.

One of the key findings from the review was that there may be an un-level playing field where a Parent Company Guarantee (PCG), or some other form of credit, is used intra-group between a wholesaler and its retail subsidiary. The review found

[1] In this letter, 'competition law' means the matters described in the Annex.

Emma Kelso, Senior Director, Customers and Casework
t. 0121 644 7554 m. 07458 016086
e. emma.kelso@ofwat.gsi.gov.uk

that many associated retailers receive credit from their wholesalers, which is permissible under the current codes. This issue was further crystallised via responses to our formal information request[2], which revealed that associated retailers of incumbent wholesalers are primarily accessing PCGs, at zero or low cost, and that these associated retailers are using PCGs in areas previously served by the relevant incumbent.

Such arrangements may raise concerns as to whether the associated retailer is genuinely bearing 60% of credit risk, as per the requirements of the Wholesale Retail Code, which is an advantage not available to other retailers with different structures and which therefore creates a potential opportunity for wholesalers to offer preferential terms to its associated retailer and for associated retailers to then price below the efficient costs of a new entrant.

We are keen to ensure that the costs of credit provided by wholesalers and borne by all retailers are reflective of a genuine market rate, and are not being used in a way to erect an unfair barrier to entry and the development of effective competition. We would in particular like to draw your attention to your respective obligations under the Competition Act 1998, and seek assurance from you that the manner in which these terms have been provided by the wholesaler, and costs have fed through into price offerings for customers by the associated retailer, has not had a negative impact on the development of competition.

All businesses are responsible for ensuring that they (and those who work for them) comply with competition law. So, depending on your assessment of the information in Ofwat's possession described above, we require you to take the following steps:

a) Carry out a self-assessment to establish how far your activities in this context comply with competition law;
b) Provide us with evidenced assurance that you are complying with the relevant competition law provisions and / or the steps that you will take to eliminate any risk of non-compliance;
c) Make or procure changes to any activities that risk not complying with competition law; and
d) Review your competition law risks regularly.

We are aware that the Market Operator (MOSL), working with the Codes Panel, is in the process of establishing a workplan to take forward a number of areas relevant to credit arrangements arising from the review, and that one of these recommendations

[2] Issued by the Authority on 7 March 2018

is in relation to PCGs. In particular, we have asked the Panel to gather evidence and assess whether the current credit arrangements give all providers an equal opportunity to compete, and specifically whether associated retailers are benefitting from unfair advantages as a result of PCGs. This includes considering whether ex-ante changes to the use of PCGs are appropriate, and to assess the pros and cons of PCG reform in general, including the impact on customers. Responses to this letter may therefore be used to inform the development of that work.

We do not provide legal advice on individual cases or issues, but guidance on competition law is available on our web pages here.

For the avoidance of doubt, Ofwat has not made a finding or formal allegation that any wholesaler or associated retailer is in breach of competition law at this time.

Within 30 days of the date of this letter please provide us with your assessment of how your activities comply with competition law and also confirm any action you intend to take to address any issues arising. Given the importance of the credit arrangements to the market as a whole, we expect any action required to be completed no later than the end of January 2019.

Please acknowledge receipt of this letter, via email, to Dan Mason at Daniel.Mason@ofwat.gsi.gov.uk.

Please contact us if you have any questions about this letter.

Yours sincerely

Emma Kelso
Senior Director, Customers & Casework

Enc.

- Anti-competitive agreements – Article 101 and Chapter I prohibition
- Abuse of a dominant position – Article 102 and Chapter II Prohibition

ANNEX

Anti-competitive agreements – Chapter I prohibition and Article 101

1. Agreements or concerted practices between businesses, and decisions of associations of businesses, which have the object or effect of preventing, restricting or distorting competition are prohibited and rendered void under Chapter I of the Competition Act 1998 (CA98) and Article 101 of the Treaty on the Functioning of the European Union (TFEU), unless exempt. The types of agreement and practices that are most likely to be caught by these prohibitions include:

    - Fixing the prices to be charged for goods or services
    - Engaging in 'bid-rigging', which involves competing businesses which are invited to bid in competitive tenders secretly colluding so that, contrary to appearances, they are not fully competing for the contract.
    - Limiting production, technical development, markets or investment
    - Sharing markets or sources of supply, and
    - Disclosure of confidential and commercially sensitive information.

2. Further details regarding Chapter I of the CA98 are available at: https://www.gov.uk/government/publications/agreements-and-concerted-practices-understanding-competition-law.

Abuse of a dominant position – Chapter II Prohibition and Article 102

3. A business will hold a dominant position in a market if it is able to behave independently of the normal constraints imposed by competitors, suppliers and customers. It is not unlawful for a business to hold a dominant position but Chapter II of the CA98 and Article 102 of the TFEU prohibit abusing such a position. In general an abuse will involve restricting the degree of competition which a business faces and/or exploiting its market position unjustifiably.

4. The types of activity most likely to be caught by these prohibitions include:

- predatory low pricing aimed at driving a rival competitor out of business;
- directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions

- limiting production, markets or technical development to the prejudice of consumers
- applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage
- making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of the contracts, and
- refusing to supply an existing long standing customer without good reason.

Further details regarding Chapter II of the CA98 are available at: https://www.gov.uk/government/publications/abuse-of-a-dominant-position.