Ofwat

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

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Open letter to all holders of Water Supply and Sewerage Licenses and their associated companies

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Credit arrangements in the Business Retail Water Market

This letter sets out our findings in relation to our recent evidence gathering on the use of parent company guarantees in the market and a reminder to Licensees of their obligations. This letter is primarily for the attention of Licensees in the Business Retail Market. However its contents, specifically in relation to obligations under Competition Law, are also relevant to associated companies of Licensees – for example, companies who may sit within the same group structure and who are providing credit to the Licensee.

In this letter we use the terms ‘Licensee’ and ‘Retailer’ interchangeably.

Background

As you will be aware, earlier this year we published the outcome of an initial review of the credit arrangements in the Business Retail Water 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 also highlighted credit as one of the key market frictions in ‘Open for Business’, our State of the Market Report, published in July 2018.

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 another form of credit, is used intra-group between a wholesaler or holding company and its retail subsidiary. The review found that many associated retailers receive intra-group credit, which is permissible under the current codes.

We sent an Advisory Letter to all associated retailers and their respective wholesalers seeking assurance that their credit arrangements, where these were in place, and retailers’ price offerings to customers were compliant with Competition Law.

Emma Kelso, Senior Director, Customers and Casework
Email: emma.kelso@ofwat.gsi.gov.uk

Our findings

We were generally satisfied by most of the responses to our Advisory Letter. Where we have outstanding questions about the arrangements being used we will be contacting retailers separately and confidentially, to better understand the precise details of the arrangements. We are aware of the work that the Credit Committee is taking forward in regards to transparency of credit arrangements more generally, and beyond this are not intending on pursuing further policy work in this area at this time. We do however, consider it useful to reiterate to retailers some of the key principles around where concerns may arise in relation to competition law.

Our view

In providing services to retailers, wholesalers face a risk that the retailer may default after it has already provided wholesale services for a period. Wholesalers cannot directly manage this risk since they have no direct relationship with end-customers nor with the management of the retailer. In order to mitigate this risk retailers are required to provide collateral to wholesalers. As per the requirements of the Wholesale Retail Code, the level of collateral that must be posted is equal to about 60% of the charges at risk of non-payment following a retailer default.

Retailers may provide this collateral in a number of ways, such as a letter of credit, a guarantee or pre-payment. We do not expect all retailers to pay the same for credit. Retailers will have different inherent business risks and their choice of credit type will also affect their credit costs. The fact that retailers may pay different rates for credit is consistent with a competitive market. Some retailers will therefore have a cost advantage over others and this is not, in and of itself, a concern.

Some retailers are part of a wider groups of companies, most of which are groups containing a wholesaler in the English water market. Where they are part of a Group, the majority of retailers have chosen to raise credit from within that Group itself, often through a Parent Company Guarantee. This is permitted under the current Codes. The current arrangements were designed to ensure that retailers bore 60% of the retail risk and wholesalers 40% of the risk. We are not concerned about the use of Parent Company Guarantees, or other forms of intra-group credit, in and of themselves.

Where a retailer is obtaining credit and paying a market orientated rate for that credit, then we do not have concerns about the impact on competition. This includes situations where a retailer may be obtaining credit more cheaply than rival retailers, but the rate it is paying for credit would be similar if it took credit from an alternative provider outside of its Group. In these situations, the economic cost of the retailer's risk is being borne by the retailer and will ultimately be recovered from customers

through its pricing. If the retailer was to fail, the impact would be borne fully by the holding company – 40% from the wholesaler's losses and 60% from the retailer's losses – but the holding company would have previously been paid the appropriate rate of return to bear this risk.

Where a retailer is obtaining intra-Group credit and paying a rate below a market-orientated rate (e.g. a zero-rate), then we would assess the situation carefully. The provision of credit at such a rate is not, in and of itself, a concern — again it is a commercial decision for the provider of that credit to determine the rate at which it lends. However, if the credit provision was below a market rate, i.e. not reflecting the economic risk specifically of that retailer (as opposed to the group as a whole), and in turn the retailer then set prices below the true economic cost at the retail level (or otherwise improved its retail offering, for example by improving quality), then there is scope for a concern, particularly if the subsequent impact on the retail market was that a retailer was able to use this to distort the market.

A retailer that is pricing below the long-term economic costs in the retail market risks engaging in an exclusionary practice within the market, keeping competing retailers out, which raises potentially serious issues under competition law, particularly where the retailer can be considered to be dominant (e.g. regionally).

We also stress that any concerns about retailers engaging in exclusionary practices are not limited or solely determined by the way in which credit is provided. Retailers should be conscious not to price in a predatory way, which would arise wherever they are pricing below economic cost in the market.

Depending on the circumstances, there may also be wider issues relating to the conduct of the wider group of companies to which a retailer belongs. We remind Appointees that under their instrument of appointment there is a requirement that "*the Appointee shall ensure that every transaction between the Appointed Business and any Associated Company (or between the Appointed Business and any other business or activity of the Appointee) is at arm's length".*

We will continue to monitor the functioning of the credit arrangements in the market closely.

Yours sincerely

Emma Kelso
Senior Director — Customers and Casework