Wholesale Retail Code Change Proposal – Ref CPW061

Modification proposal	CPW061 – Unsecured Credit Allowance reflecting payment history
Decision	The Authority has determined that it cannot properly form an opinion on the approval of the Change Proposal and requests that the Panel revise and resubmit a Final Report
Publication date	23 September 2019
Implementation date	N/A

Background

Ofwat commissioned a review of credit arrangements in the Non-Household retail market from KPMG. The KPMG review of credit arrangements for the non-household retail market ("**the KPMG Report**"), published in June 2018, made a number of recommendations, including to amend the unsecured credit arrangements to better reflect the reduced risk of Retailers with a strong payment history. It was suggested that credit referencing agencies could be engaged with to establish arrangements whereby payment histories of different Retailers, ideally across all wholesale areas, could be obtained and reflected in the credit scoring reports they provide.

The KPMG report recommended that a Change Proposal could be developed to create an Unsecured Credit Allowance option to reflect strong payment history, and could be based on the values taken from credit scoring reports. It further noted that this amendment to the credit terms would improve the arrangements for smaller new entrants.

The issue

This Change Proposal was developed by a working group of the Panel (the Credit Committee) in response to the recommendations in the KPMG report.

The KPMG report found that small new entrant Retailers, without a credit history, find it difficult to obtain a credit score or rating on which to access an Unsecured Credit Allowance and this may discourage new entrants from entering the market. It was suggested that new entrants could access Unsecured Credit Allowance through the inclusion of unsecured credit values available for strong payment histories.

The modification proposal[1]

The Credit Committee considered a range of options for a new Unsecured Credit Allowance. The Change Proposal developed by the Credit Committee introduced an additional option to receive an Unsecured Credit Allowance based on Payment Performance into the Wholesale Retail Code (WRC).

The following modifications have been proposed:

- Retailers can access an additional Unsecured Credit Allowance based on Payment Performance and that this should be applied cumulatively, up to a maximum combined Unsecured Credit Allowance of 40%, if combined with Trade Credit Insurance, Current Credit Score or Current Credit Rating.
- Where good Payment Performance has been held for six Months, an allowance of 10% Unsecured Credit Allowance is applied and after 12 Months of good Payment Performance, this would increase to 20%.
- If there was a partial, late or missed payment, this allowance based on Payment Performance would automatically revert to 0%.
- Good Payment Performance requires full payment of Primary Charges as well as provision and maintenance of Credit Support Balances and Credit Support Amounts by the due date in accordance with Section 9 of the Business Terms. The amounts in dispute under Section 9.7.2 are excluded. Full payment on the due date will be as agreed between the Wholesaler and the Retailer in the Alternative Payment Terms under Section 9.2.1(c).

Industry consultation and assessment

A Request for Information on the draft Change Proposal (DCP020) was published on 7 March 2019 and closed on 21 March 2019. There were a total of 19 responses received, 12 from Wholesalers and seven from Retailers.

Agreement with the proposed solution

The majority (14 respondents) agreed with the proposed solution. The main reasons cited were that this change would encourage new entrants into the market, improving competition and further promoting a level-playing field.

One Wholesaler respondent stated that the proposed change would increase the incentive for Retailers to make full payments on time. It highlighted that currently there is no penalty, financial or otherwise, for Retailers that make late or partial payments. One Retailer suggested that this change would increase competition in the market for the benefit of customers. Another Retailer suggested that the reduced

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

cost of credit should allow Retailers to free up working capital to pursue market friendly and innovative agendas.

The majority of the five respondents that did not agree with the proposal were Wholesalers. One Wholesaler respondent stated that payment history is not a true representation of a Retailer's credit history and cannot be measured in the same way as a credit score. Another Wholesaler highlighted that there was a distinction between a Retailer's payment history, credit score and credit rating. It suggested that a distinction should be maintained between the three and reflected in the level of Unsecured Credit Allowance available.

A Wholesaler that disagreed stated there was adequate provision of credit options for Retailers and that allowances should not be stackable. This view was also shared by two other Wholesalers. The Wholesaler further stated that offering Unsecured Credit Allowance as proposed, would mean transferring additional risk onto the Wholesalers and using them to reduce the cash flow requirements of Retailers.

A Wholesaler suggested that if a Retailer relying on the proposed Unsecured Credit Allowance method were to miss a payment and the facility is withdrawn, this could result in the Retailer being unable to fund its business. It argued that this would ultimately impact end customers.

One Wholesaler accepted that it would be difficult for new entrants to gain a credit score or credit rating however, highlighted that there were other alternatives. It considered that new companies would be well known to their banks and able to obtain a bank guarantee or letter of credit.

One Wholesaler was supportive of the principle that Retailers that are unable to access an Unsecured Credit Allowance based on a credit score or rating could rely on payment history to obtain access to an Unsecured Credit Allowance. However, it did not agree with the proposal that supplements existing allowances with additional Unsecured Credit Allowances.

A Wholesaler considered that the proposed approach essentially double counts good Payment Performance to allow access to an Unsecured Credit Allowance. It also suggested that the Credit Committee reconsiders its decision not to have a three year time limit which is applicable for Trade Credit Insurance. It highlighted that this was sufficient time to build up a good credit score/rating.

One Retailer, whilst agreeing with the proposed change, said that it was concerned that strong payment history may not necessarily reflect credit worthiness of a new company. It suggested that the levels set should be reviewed regularly to assess appropriateness.

Red line drafting

14 respondents agreed with the red line drafting reflected in the solution. Five respondents, four Wholesalers and one Retailer, did not agree. Four of the five respondents that did not agree, did not agree with the overall proposed change.

The Retailer, whilst agreeing with the proposed solution, did not agree with the proposed red line drafting. It suggested that this did not take into account situations whereby a Retailer may legitimately make a part payment or withhold payment. It argued that the drafting does not take account of the complexities of payment nor does it provide any flexibility for late payment issues, for example systems failures.

Level of the allowance

13 respondents agreed with the proposed levels of allowance, 10% for six Months and 20% for 12 Months. Six respondents, five Wholesalers and one Retailer, did not agree with the proposed levels of Unsecured Credit Allowance.

Those that were in agreement provided reasons such as, the levels seemed reasonable and were reflective of the impact of a good payment history. One Retailer respondent that was in support of the proposed levels suggested that they provide sufficient incentive for Retailers, however it suggested that the allowance should seek to reflect a carry over, or incorporate payment behaviour, where a Retailer qualifies for an additional 10% Unsecured Credit Allowance after six months.

Most respondents that did not agree with the proposed levels, did not agree with the proposal overall. One Retailer did not agree with the proposed timescales for access to Unsecured Credit Allowance, it suggested that 10% should be accessible after three Months and 20% after six months. It also expressed concern that the levels do not reflect a realistic maximum level and are discriminatory. It considered that there should be an equivalent level of credit security obtainable through a credit score as through a credit rating, otherwise small companies are actively disadvantaged in the market.

One Wholesaler did not agree with the proposed level of allowance, due to the general disagreement of combining payment performance and credit scores. It also stated it would have agreed with the proposed levels of allowances following the condition that credit score and Payment Performance were considered as alternative forms of Unsecured Credit Allowance. They further stated that a lower threshold of 5% after six months and 10% after 12 months would be more appropriate.

Views on level automatically falling to 0% if payment is late or missed

14 respondents agreed that the proposed levels of Unsecured Credit Allowance should automatically be decreased to 0% in the event of a late or missed or partial payment. Five respondents, three Retailers and two Wholesalers, did not agree.

The majority of respondents agreed with this proposal. They highlighted that this would incentivise Retailers to maintain good payment performance. It was highlighted by one Wholesaler that the risk exposure would be mitigated by the payment record. Another Wholesaler, whilst not in agreement with the proposal, suggested that this mechanism provides a valuable safeguard for Wholesalers against increased risk. Another Wholesaler suggested that following a late, missed or partial payment a longer timeframe should be imposed before the relevant Retailer could again use this method to access Unsecured Credit Allowance.

One Wholesaler respondent highlighted that it would look to engage with the Retailer to understand the reason for late payment. Another Wholesaler considered that this would motivate Retailers to maintain good payment performance, however it questioned whether this could be open to judgement calls, for example where there had been a system error.

One Wholesaler asked the Credit Committee to consider whether late payments should be centrally reported and where a payment is missed on one wholesale area, whether this should affect Payment Performance across all wholesale areas.

A Retailer did not agree that the amount of Unsecured Credit Allowance should revert to 0% after one late, part or partial payment. It argued that this is not flexible and suggested a 'cure period' for genuine errors to be corrected without penalty.

View on whether the limit for Unsecured Credit Allowances should remain at 40% where payment performance is being used alongside other methods of acquiring Unsecured Credit Allowance

14 respondents agreed with the 40% limit. Five respondents, three Wholesalers and two were Retailers, disagreed.

Those in support of the 40% limit mostly cited that the limit strikes a fair balance of risk between Wholesalers and Retailers. One Wholesaler did not agree on the basis that it did not support Unsecured Credit Allowances being cumulative but supported the 40% limit for Retailers with a minimum credit rating.

One Retailer disagreed with the capping of Unsecured Credit Allowance at 40%, with the rationale being it prevents creditworthy companies from being able to leverage their favourable credit rating and take advantage of their lower risk to increase the level of discount available. It also stated that the current proposed format should not seek to punish already well performing new and existing Retailers.

Implementation Date

13 respondents agreed with the proposed implementation date of 30 September 2019. Five Wholesaler respondents disagreed with the proposed implementation date and one Wholesaler stated non-applicable. Those that did not agree, were on the basis that they did not support the proposal. In contrast, a Retailer that disagreed with the proposed implementation date suggested an earlier implementation date.

Objectives and Principles of the WRC

12 respondents agreed that the proposed change better facilitated the WRC objectives and principles. Six Wholesaler respondents disagreed and one Wholesaler stated non-applicable. Those that agreed stated that this change better facilitates the objectives of the WRC by improving barriers to entry, efficiency, and non-discrimination.

Committee views following the Request for Information

Following the Request for Information, the Credit Committee considered the points raised by respondents. The Credit Committee agreed to retain the following elements of the proposed solution:

- Additive Unsecured Credit Allowance, although some respondents stated that making it additive increased wholesalers' exposure.
- Not to limit access to the Unsecured Credit Allowance to three years from becoming a Trading Party, as it was considered that an existing Trading Party could take advantage of its historical Payment Performance.
- The level of Unsecured Credit Allowance when combined with a credit score Unsecured Credit Allowance is equivalent to an investment grade rating, which respondents criticised.
- The allowance should immediately revert to zero where there was a partial, late or missed payment, despite some respondents arguing it was too inflexible.

In relation to the final bullet point, the Credit Committee noted the concerns raised regarding extenuating circumstances that may lead to missed payment, for example system errors. As these events were considered rare, it was highlighted that this was Retailers' and Wholesalers' responsibilities to manage their own risks and deal with rare technical issues as part of normal business practice.

Panel recommendation

The Panel considered this Change Proposal at its meeting on 28 May 2019. It recommended that the Authority reject this proposal with nine members voting in favour and two voting against.

The votes cast in favour of the proposal was on the basis of improving the principles of efficiency, proportionality, barriers to entry and non-discrimination. The two members who voted against the proposal provided the rationale that they disagreed with the solution, stating they did not consider it to be proportionate given that it had the potential to reduce Retailers' credit requirements and increase Wholesalers' risk. It was also highlighted that the solution was inconsistent with the current Unsecured Credit Allowance structure which limits a Retailer using Trade Credit Insurance to a 20% Unsecured Credit Allowance compared to a potential combined 40% Unsecured Credit Allowance, which is equivalent to a good credit score with an investment grade rating.

Our decision

We have considered the issues raised by the modification proposal and the supporting documentation provided in the Panel's Final Report. Based on the information and evidence provided, we cannot properly form an opinion and are therefore returning this Change Proposal to the Panel for it to revise and resubmit a Final Report. The revised Final Report should be submitted to us no later than 31 January 2020.

Reasons for our decision

We support the principle of Unsecured Credit Allowances being available based on strong Payment Performance history and are supportive of promoting new entry and promoting a level playing field within the market. However, we have not seen sufficient evidence that the Credit Committee has fully considered or sought to address the concerns raised by some respondents to the Request for Information. We have detailed below our concerns with the proposal as it is currently proposed.

Availability of Payment Performance for Retailers

A key issue this Change Proposal seeks to address is that new entrant Retailers can have difficulty obtaining access to credit, and we understand that the cost of credit for new entrant retailers can be a significant proportion of their operating costs. The Panel's Final Report does not provide sufficient rationale to support the argument that this should be available for all Retailers given that those who have had time to build a credit score/rating should be able to rely on the current Unsecured Credit Allowance options provided in the WRC.

Monitoring Payment Performance across wholesale areas

With regard to the operation of Payment Performance monitoring in individual wholesale areas, we have concerns that this does not provide a full picture of a Retailer's Payment Performance. It could also provide a perverse incentive if a Retailer experiences a cash flow issue to target payments to the wholesale area(s) where its Payment Performance allowance is the most valuable to prevent losing this. We recommend that consideration should be given to monitoring Payment Performance across all wholesale areas.

Cumulative access to Unsecured Credit Allowances

We note that the proposal as drafted would enable Payment Performance to be applied cumulatively with access to Unsecured Credit Allowances based on Trade Credit Insurance. If a Retailer was to combine these options it could potentially access an Unsecured Credit Allowance of 40%, which is equivalent to what is currently available for a Retailer that has a Current Credit Rating.

We have some reservations regarding the ability for Payment Performance to be applied cumulatively with Trade Credit Insurance, particularly with the current proposal being that Payment Performance will be monitored across individual wholesale areas as opposed to collectively across all wholesale areas. Neither the proposed Payment Performance nor Trade Credit Insurance require an overall assessment of a Retailer's risk of default before they can be accessed. However, we note that if the proposal is amended so that Payment Performance is monitored collectively across every wholesale area then there are different implications as Payment Performance would arguably be more reflective of the likely risk of default. It is for the Credit Committee – calling upon expert advice as necessary – to work through these issues and present clear evidence to support their recommendation.

We also note the Credit Committee discounted limiting Payment Performance to three years, similar to arrangements in place for Trade Credit Insurance for new entrant Retailers. The Credit Committee should also provide rationale as to why this decision was made along with supporting evidence.

Automatic revision of 0% Unsecured Credit Allowance

In addition to the above, we think there could be potential unintended consequences from automatic reversion to 0% Unsecured Credit Allowance under Performance Payment after one late, missed or partial payment. If a Retailer has elected to rely on

Payment Performance across a number of wholesale areas and, for example, subsequently makes a non-compliant payment across all of those areas due to an error, its Unsecured Credit Allowance across all of the affected areas would revert to 0%. This could potentially have an adverse impact on its ability to continue to operate in the specific wholesale areas and could be at the detriment of customers. It is recommended that the Credit Committee give consideration to options for staggering the removal of Payment Performance following late, missed or partial payments. Alternatively, the threshold for reversion to 0% availability could be increased or an element of flexibility added to enable Wholesalers to make this determination.

Decision notice

In accordance with paragraph 6.3.8 of the Market Arrangements Code, the Authority cannot properly form an opinion therefore returns this Change Proposal to the Panel for it to revise and resubmit a Final Report that responds to the issues specified in our decision.

We support the principle of Unsecured Credit Allowances being available based on strong Payment Performance history and are very supportive of promoting a level playing field that facilitates new entry within the business retail market. We therefore ask the Panel to revise and resubmit a Final Report to us no later than 31 January 2020.

Georgina Mills
Director, Business Retail Market