

Wholesale Retail Code Change Proposal – Ref CPW079

Modification proposal	Wholesale Retail Code Change Proposal – CPW079 – Protections for Credit Support Security
Decision	The Authority has decided to approve this Change Proposal, subject to some amendments to the legal drafting
Publication date	12 February 2020
Implementation date	14 February 2020

Background

Schedule 1, Part 2: Business Terms under the Wholesale Retail Code (“WRC”) sets out the credit provisions between Retailers and Wholesalers in the business retail market. Retailers must lodge credit in advance where they opt to post pay their Wholesale Charges. The credit can be provided through one or more forms of Eligible Credit Support as well as through Alternative Eligible Credit Support negotiated between the Wholesaler and Retailer, as set out in Schedules 2 and 3 of the Business Terms. The Credit Support Amount (i.e. the level of credit support), must be provided and maintained at all times. It is adjusted to reflect the expected usage of Water and Sewerage Services on a Monthly basis. It is achieved by the Retailer providing a Credit Support Balance or the Wholesaler holding or returning any Excess Eligible Credit Support Amount¹.

If the Retailer and Wholesaler disagree over the Credit Support Amount it can be resolved through the standard disputes processes, followed by arbitration. Where a Retailer fails to provide and maintain its Credit Support Amount or provide its Credit Support Balance at a certain point, it will be classified as a Defaulting Trading Party. Being a Defaulting Trading Party is a condition for a Wholesaler drawing down what it is owed under any credit support agreements, such as a Letter of Credit.

¹ Excess Eligible Credit Support Amount is the value of Eligible Credit Support (and/or Alternative Eligible Credit Support) held by the Wholesaler which is available to be called upon and is more than is required to be provided by the Retailer. Section 9 of the Business Terms provides details of when a Wholesaler is entitled to hold such amount.

The issue

The current requirements relating to credit security, meaning credit cover provided as Eligible Credit Support and/or Alternative Eligible Credit Support, are designed to mitigate the risk to the business retail market arising from Retailer insolvency.

This Change Proposal was raised by Castle Water (the “Proposer”) who contends that the requirements on Retailers are disproportionate to those imposed on Wholesalers, relative to the respective risks they pose. In particular, the Proposer suggests that the obligations in the Business Terms do not currently provide for a situation where a Wholesaler calls or draws on credit security above the level of payment owed by a Retailer. It considers that in such circumstances, a Retailer would be required to provide additional credit security with the risk that the Wholesaler may not return any such excess draw-down on credit security, resulting in increased overall costs for the Retailer.

The Proposer considers that if excess credit security is drawn down by a Wholesaler, the Retailer could be found in default by the Wholesaler if the Retailer does not provide additional Credit Security to replace what was drawn down. The Proposer argues that this could lead to termination of the Retailer’s contract. Where a Retailer is correctly classed as a Defaulting Trading Party under one Wholesale Contract it will also be considered a Defaulting Trading Party under all its other Wholesaler Contracts in accordance with Section 10 of the Business Terms of the WRC.

The Proposer contends that it has frequently seen disagreements between Retailers and Wholesalers over what sums are payable where specific Wholesale Charges are in dispute (this was not evidenced in the Panel’s Final Recommendation Report). They believe there is no workable provision for a Retailer to agree, to challenge, or to dispute a decision by a Wholesaler to draw on any credit security provided by a Retailer. Furthermore, the Proposer contends that the WRC disputes and arbitration provisions would not provide an adequate route of remedy in the timescale (possibly of a day or days) that might be available to resolve credit matters.

Case of Urgency

Section 4 of the Panel’s Final Recommendation Report sets out rationale provided by MOSL and the Proposer on the case for urgency for CPW079. In summary, the Proposer contends that Ofwat’s recent publication of PR19 Final Determinations on 17 December 2019 could put a number of the Wholesalers’ credit metrics under increased pressure in the coming months. In their view, a number of plausible sequences of events could trigger this situation. As such, they believe urgent action is needed.

In the industry consultation undertaken (detailed below), three Wholesalers provided the view that the Change Proposal did not meet the criteria for an urgent Change Proposal.

MOSL provided the view that technical treatment and consequential effects of any Credit Support Amounts drawn in excess of payments outstanding has been a risk since market go-live. They noted that this risk has, to date, not manifested as an issue. They also noted that the case for urgency is predicated on any change in the risk profile associated with this matter. This risk relates directly to the financial outlook for Wholesalers, particularly their credit ratings outlook.

The Change Proposal²

The purpose of this Change Proposal is to ensure that the risk of systemic market failure is minimised and for customers to have the maximum level of confidence in the market. The solution seeks to:

- Relieve Retailers of the obligation to provide credit support (Eligible Credit Support and/or Alternative Eligible Credit Support) if the Wholesaler has drawn credit support in excess of the amount due; and
- Dis-apply the provisions relating to Retailer default and termination in relation to credit support during such periods in favour of resolution by referral to the Authority.

Specifically, the Change Proposal seeks to:

- Add a new Section 9.14.2 to the Business Terms which states that:
 - a) A Wholesaler is not entitled to draw any sums in excess of those owed or due by the Retailer to the Wholesaler taking account of amounts disputed or questioned under Section 9.7.2.
 - b) In the event that the Wholesaler draws more credit than it is owed or due, the Retailer does not need to provide credit cover (as Sections 10, 11 are disappplied in relation to this) but stays on Post-Payment and cannot become a Defaulting Trading Party until the excess drawn is returned.
 - c) Any disagreement over the application of this section may be referred to Ofwat for determination.

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

Industry consultation and assessment

An industry consultation was published on 23 October 2019 and closed on 19 November 2019. There were a total of 21 responses received, 13 from Wholesalers, seven from Retailers and from CCWater.

This Change Proposal has evolved from the position where it was raised on an urgent basis and originally consisted of two parts. The first part (Part A) being where a Wholesaler draws down more credit security than it is owed and the second part (Part B) was where a Wholesaler's credit rating falls below investment grade.

The solution recommended in the Panel's Final Recommendation Report focuses on the Part A of the original solution in relation to a Wholesaler drawing down more Credit Security than it is owed. We focus here specifically on the questions in relation to this element of the original proposal, although some of the responses may be impacted by views on Part B of the original solution.

Views on addressing circumstances in which a Wholesaler draws on credit security above the level of payment owed by a Retailer

Overall, views were provided that the WRC would benefit from being clearer on Wholesalers not being able to draw down more credit security than it is owed. This view was expressed by two Wholesalers, whilst a Retailer noted that an "Unpaid Amount" was clearly referenced in the Letter of Credit template (Business Terms Schedule 2C) and commented that it was not persuaded that the Change Proposal was necessary.

An additional Retailer was surprised that there could be instances where a Wholesaler could draw on more than it was owed and said it would support updates to the WRC to prevent this. A Wholesaler supported this view and stated that change should be made to the WRC to ensure that sums provided to a Wholesaler were in a designated cash security account. A further Wholesaler thought that the appropriate solution may be to consider ring fencing any funds.

A number of respondents also referenced that the Change Proposal would benefit from being worked up by the Credit Committee where the issues could be further investigated.

View from the Proposer

In summary, the Proposer noted that most Trading Parties responding to the consultation agreed that it should not be possible to draw on credit security above the level of payment owed by a Retailer. It further stated that those who objected to

the change were objecting on the basis of the need for the change rather than the principle, with a number suggesting that they could not anticipate circumstances when the event could happen or claim that it cannot happen.

The Proposer stated that the WRC currently contains a loophole which prevents Retailers from agreeing, challenging or disputing a decision by a Wholesaler to draw on any credit support security provided by Retailers. Therefore, CPW079 provides protection that no Wholesaler draws on credit security above the level owed by a Retailer.

The Proposer acknowledged the suggestions from some respondents that the Change Proposal should be further assessed by the Credit Committee but noted that this would take time and it would be a mistake to delay a decision to implement CPW079.

Views on the proposed disapplication of Sections 9, 10 and 11 of the Business Terms in relation to credit cover in Sections 9.14.2

Four respondents (three Retailers and one Wholesaler) agreed with the proposed disapplication of Sections 9 (Billing and Terms of Payment – including credit), 10 (Default – listing the ways Retailers may go into Default) and 11 (Termination – of the Wholesale Contract) of the Business Terms in relation to credit cover. Fifteen respondents (11 Wholesalers and four Retailers) disagreed with one Wholesaler not agreeing or disagreeing.

A Wholesaler agreed in relation to changes suggested to Section 9.14.2 in relation to disapplication of Section 9, 10 and 11 of the Business Terms if the Wholesaler draws on more credit cover than it is owed. A Retailer agreed but stated that any protections in this area should be proportionate, and therefore believed further analysis would be required to ensure that any solution works for the market.

A Wholesaler who disagreed noting that there was an increased risk for a Wholesaler where it was unable to recover any credit support in the case of Retailer default. In addition, they did not understand how the drafting worked with the specific reference to Section 9.7.2, which excludes disputed or questioned amounts, in Section 9.14.2 that dis-applied the whole of Section 9. They also pointed out that while a Retailer was determined not to be a Defaulting Trading Party it could go into default for other reasons. A further Wholesaler said that there was not sufficient explanation why a Retailer should be absolved from providing the full Credit Support.

Views on the circumstances covered by proposed Section 9.14.2 and Section 9.11.8 (relating to Part B in the original solution) to require a specific referral mechanism to Ofwat

Overall, five respondents (three Retailers and two Wholesalers) agreed that the circumstances covered by the proposed solution would require a specific referral mechanism to Ofwat. Fourteen respondents (ten Wholesalers and four Retailers) disagreed and one Wholesaler did not provide a response.

The Proposer stated that a Retailer was not protected against Wholesaler insolvency or special administration and needed this to supplement Ofwat's existing measures. A Retailer supported it due to the ramifications and need for speedy resolution. A further Retailer also noted how lengthy the dispute and arbitration processes were. A Wholesaler considered Ofwat as the most appropriate body to deal with an issue of this nature.

Those respondents who did not support this approach cited a number of reasons: no need for a specific mechanism; better addressed by prevention or clarification; and existing processes should be followed. A Wholesaler considered referral to Ofwat as the last resort and a Wholesaler and Retailer stated that they did not consider that sufficient justification had been provided by the Proposer on why this issue should be escalated to Ofwat.

CCWater highlighted that they were uncertain as to the circumstances leading to, and level of risk in which, a Wholesaler would require credit support in excess of the amount owed by a Retailer.

View from the Proposer

In summary, the Proposer acknowledged that the majority of respondents questioned the need for a specific referral mechanism to Ofwat. It notes that Ofwat accepted that it has a role in forestalling or mitigating the effect on the sector and on customers, through its processes and its functions in relation to enforcing the ring fences, reducing the impact of Retailer exit, making interim supply arrangements, and special administration. As such, it foresees this proposal to supplement these measures as a timely resolution mechanism.

Views on whether the proposal better facilitates the objectives and principles of the WRC

Six respondents (five Retailers and one Wholesaler) agreed that this change better facilitates the Objectives and Principles of the WRC, citing that it removed barriers to

entry by reducing the risk for new entrants and created a level playing field for Retailers.

Thirteen respondents (eleven Wholesalers and two Retailers) disagreed that this change better facilities the Objectives and Principles of the WRC. The main reason cited was it seemed to be disproportionate to the issues that it was trying to resolve.

A Wholesaler stated that this proposal was of the benefit of a sole beneficiary rather than necessarily being in the best interests of the market.

Two Retailers stated that the proposal was disproportionate to the risk proposed and would discriminate in favour of those Retailers who choose to post-pay rather than pre-pay.

Views on whether the proposal provides benefit to customers

Seven respondents (five Retailers and two Retailers) agreed that the proposed change would benefit customers. Reasons cited included that the change had the potential to benefit customers by removing barriers to entry to the market and could improve customer confidence in the market.

The Proposer stated that the change benefits customers and stated it reduces the risk of further disruption to the business retail market and protects customers' money, as well as that of Retailers. A Wholesaler stated that there could be customer benefits if any savings made by Retailers were passed on to customers.

Ten respondents (eight Wholesalers and two Retailers) disagreed that the proposed change benefits customers. Those that disagreed saw no benefits to customers or negative effects such as increased bad debt and market destabilisation.

CCWater stated that there were no clear benefits to customers. They further stated that the Proposer may argue the proposed change will reduce the risk of Retailer insolvency, and provide better protection against potential Wholesaler insolvency, but the risks may be low. They noted that further evidence of whether this is a market-wide issue needed to be shown.

MOSL's view on the consultation responses

MOSL notes that a number of respondents to the industry consultation stated that the Change Proposal requires further consideration to develop a satisfactory solution and that some have specifically stated that it should be considered by the Credit Committee.

MOSL acknowledges that respondents stated that the Change Proposal addresses the issue that a Retailer's credit support is not ring-fenced in an indirect way, which does not fully resolve the issue and which Wholesalers argue potentially reduces market stability. They further raise an issue concerning the disapplication of Sections 9, 10 and 11 of the Business Terms to put the credit support arrangements on hold but which may have unintended consequences.

In addition, MOSL notes that many respondents have said the WRC could benefit from clarity on what happens when a Wholesaler draws down more than it is owed in relation to proposed Section 9.14.2 of the Business Terms. However, the Change Proposal does not set out a mechanism to return any overdrawn credit support. Furthermore, the proposed Section 9.14.2 in the Business Terms prevents a Retailer from being a Defaulting Trading Party during this period, which would appear to close legitimate courses of actions to Wholesalers.

Finally, MOSL advises that when looking for an adequate solution to the issue of the security of credit lodged with Wholesalers, the costs of setting up ring-fencing would need to be compared with the benefits, and would take some time to fully assess.

Panel recommendation

The Panel considered this Change Proposal at its meeting on 10 December 2019. The Panel noted its view that a Wholesaler should not be able to draw down more than it was owed. While agreeing with this, a Panel Member expressed concern regarding the reference to Section 9.7.2 of the Business Terms. In their view, this could allow Retailers to withhold amounts disputed or subject to question and this created the potential for Retailers to restrict Wholesalers from drawing down on credit because such disputed payments are not to be treated as outstanding. The Panel Member concluded that they felt the Change Proposal was poorly thought through and did not benefit the customer.

A further Panel Member asked why the problem could not be addressed by modifying the drafting to make it clear that the Wholesaler was not entitled to draw down more than it was owed.

Other Panel Members felt that, on balance, the Change Proposal would improve the stability of the market and deliver benefits as outlined by the Proposer by providing clarity, and redressing imbalances in the financial exposures of Trading Parties.

The Panel recommended that Ofwat approve this proposal. The vote consisted of ten votes in favour, 1 against and one abstention. This recommendation has been made on the basis of improving the principles and objectives of efficiency,

proportionality, barriers to entry, simplicity, cost-effectiveness, security and non-discrimination and customer participation.

The Panel observed that the gap in the WRC needed to be dealt with as quickly as possible given the potential impacts of a Wholesaler drawing down on excess credit amounts. The Panel agreed that an expedited implementation timetable should be recommended for this change. The recommended date of implementation is three Business Days after an Ofwat decision.

Our decision

We have considered the issues raised by the Change Proposal and the supporting documentation provided in the Panel's Final Recommendation Report and have decided to approve CPW079, subject to amendments being made to the legal drafting. We have concluded that the implementation of CPW079 will better facilitate the principles and objectives of the WRC as detailed in Schedule 1 Part 1 Objectives, Principles and Definitions, and is consistent with our statutory duties.

Reasons for our decision

We support the principle of the Change Proposal to ensure that Wholesalers cannot draw on any credit from Retailers where money is not owed. Having carefully considered the proposed legal drafting, and the views raised by Trading Parties in the Industry Consultation, we believe that Section 9 and Schedules 2 and 3 of the Business Terms lacked clarity as to when credit can be drawn down, especially where part payment has been made and the Wholesaler is seeking to enforce its rights in relation to the rest of the monies it is owed. We therefore support the first part of the proposed legal drafting to the WRC Schedule 1, Part 2: Business Terms, as follows:

The Contracting Wholesaler shall not be entitled to draw on any Eligible Credit Support or Alternative Eligible Credit Support in excess of sums owed and due to the Contracting Wholesaler at that time (amounts subject to disputes or question pursuant to Section 9.7.2 shall not be considered to be owed or due).

It is our view that it is reasonable to limit the amount of Eligible Credit Support or Alternative Eligible Credit Support where a Contracting Wholesaler has drawn down on more credit support than they are owed, but only to the extent of that excess. Credit support should still be provided where legitimately required over and above the excess drawn down. In addition, we do not believe the reference to a Defaulting Trading Party is required as the Retailer would not be considered a Defaulting Trading Party where excess drawn down of credit had occurred and further top up

was required in excess of the amount owed and due. It is also not reasonable to remove the requirement to provide any Eligible Credit Support or Alternative Eligible Credit Support in its entirety. We are therefore approving the implementation of modified legal text to that proposed drafting in CPW079, as follows:

... Should the Contracting Wholesaler draw on any Eligible Credit Support or Alternative Eligible Credit Support in excess of sums owed and due (contrary to this Section 9.14.2), the amount of Eligible Credit Support or Alternative Eligible Credit Support that the Contracting Retailer is required to provide pursuant to Section 9 shall be reduced by the amount that the Contracting Wholesaler drew upon in excess until such time as that excess amount is reimbursed to the Contracting Retailer by the Contracting Wholesaler.

Finally, whilst we understand the Proposer's intention to escalate disputed matters to Ofwat, overriding other parts of the Business Terms to address concerns about the speed at which disputes on this may be resolved, we do not believe the proposed drafting will achieve this. There is no guarantee as to the timeframe in which Ofwat would handle a case as such as this. This is because we carry out a range of different investigations and enforcement activity, from large and complex investigations into alleged breaches of competition law to small issues affecting individuals. We only intervene when we are best placed to do so, with our intervention being proportionate, timely and based on evidence. Where possible, we try and minimise the resource we can use on non-strategic cases which could be resolved by other means³. As such, Part I of the Business Terms clearly sets out how disputes should be handled, and Ofwat has powers under the Water Industry Act 1991 to direct parties who do not comply with the WRC to amend their behaviour. Therefore, the inclusion of a mechanism for Ofwat to deal with disputes of this kind is unnecessary. We are therefore rejecting the proposed legal drafting.

To summarise we are approving the implementation of the following legal text in the WRC Schedule 1, Part 2: Business Terms:

9.14.2 *The Contracting Wholesaler shall not be entitled to draw on any Eligible Credit Support or Alternative Eligible Credit Support in excess of sums owed and due to the Contracting Wholesaler at that time (amounts subject to disputes or question pursuant to Section 9.7.2 shall not be considered to be owed or due). Should the Contracting Wholesaler draw on any Eligible Credit Support or Alternative Eligible Credit Support in excess of sums owed and due (contrary to this*

³ Further information of Ofwat's process for investigations found here:
<https://www.ofwat.gov.uk/regulated-companies/investigations/how-we-investigate>.

Section 9.14.2), the amount of Eligible Credit Support or Alternative Eligible Credit Support that the Contracting Retailer is required to provide pursuant to Section 9 shall be reduced by the amount that the Contracting Wholesaler drew upon in excess until such time as that excess amount is reimbursed to the Contracting Retailer by the Contracting Wholesaler.

We have set out below our views on the code principle better facilitated by the Change Proposal.

Simplicity, cost-effectiveness and security

We support the Panel and Proposer's view that the proposed change is simple and cost-effective, and will improve the stability of the market by providing appropriate mechanisms to clarify and enforce Wholesalers to not draw on excess sums of Eligible Credit Support or Alternative Eligible Credit Support.

Decision notice

In accordance with paragraph 6.3.7 of the Wholesale Retail Code, the Authority approves this Change Proposal.

**Emma Kelso
Senior Director, Markets and Enforcement**