Wholesale Retail Code Change Proposal – Ref CPW100

Modification proposal	Wholesale Retail Code Change Proposal – CPW100 – Revision to Credit Support Requirement under CPW095
Decision	The Authority has decided to reject this Change Proposal
Publication date	4 August 2020
Implementation date	5 August 2020

Background

The Business Terms provide three payment terms options for the payment of Primary Charges from Retailers to Wholesalers:

- Pre-Payment;
- Post-Payment; and
- Alternative Payment Terms.

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[1] and/or (with the agreement of the Wholesaler) Alternative Eligible Credit Support to meet the Credit Support Amount[2].

The value of credit support that a Retailer is required to provide to the Wholesaler(s) that it contracts with is normally calculated based on the value of each Settlement Report provided by the Market Operator. Settlement Reports are calculated based on the consumption, or estimated consumption, of Retailers' customers in each given Area.

[1] The various forms of Eligible Credit Support are set out in Schedules 2 and 3 of the Business Terms
[2] 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)

With the ultimate aim of protecting business customers during the Covid-19 pandemic, Ofwat approved a series of urgent and temporary Change Proposals, initially:

- CPW091 - Given the challenges associated with getting meter reads during lockdown businesses were likely to be billed on the basis of (higher) historic meter reads. To ensure charges more accurately reflect (reduced) levels of consumption, in March we approved CPW091 which enabled Retailers to temporarily apply the vacant flag in the Central Market Operating System (CMOS) where premises have closed down due to Covid-19[3]; and
- CPW093 - Which enabled Retailers to temporarily defer up to 50% of Wholesale Charges in March 2020, and from Settlement in April and May 2020.

The combined effect of these changes increased the bad debt risk to Wholesalers as the Credit Support Requirements were based on Settlement Reports which would have been substantially lower due to increased vacant premises, while at the same time Retailers that chose to defer a proportion of their Wholesale Charges would owe Wholesalers more money.

To address an unintended consequence of CPW091, through CPW095, Credit Support Requirements were maintained at pre-Covid (that is, March 2020) levels for Retailers that had not deferred Wholesale Charges. CPW095 was superseded by CPW096, which extended the requirement to maintain Credit Support Requirements at the March 2020 level to all Retailers, regardless of whether or not they have deferred any Wholesale Charges. The rationale for this was to mitigate the increased risk to Wholesalers arising from a potential reduction in the level of credit support required through Retailers' applying the temporary vacant flag, and, for prudential reasons, to protect Retailers from encountering a cliff-face in the provision of credit support when vacant flags are switched off and consumption begins to rise. CPW096 also provided an extension to the period over which Wholesale Charges can be deferred, further details can be found in the decision document.

At the same time as publishing our decision on CPW096, we also published our decision to cap the increased exposure that Wholesalers bear from the liquidity arrangements we have put in place, to the average monthly charge for the failed Retailer. Until the cap is reached, any increased bad debt costs not covered by the

[3] CPW091 allowed Retailers to use a bespoke temporary vacancy flag where a premises: (a) is not open or available to workers, the public or visitors; or (b) usual activities at the premises had fallen by 95% (as a proxy for a similar reduction in consumption).

credit arrangements in the business retail market will be shared with customers through the totex sharing mechanism. Once the cap is reached, all bad debt costs from the failed Retailer resulting in the increased exposure are borne by customers.

In July 2020, Ofwat consulted on next steps following the temporary response to Covid-19, including a proposal in relation to ongoing Credit Support Requirements. Our proposal was to require Retailers to maintain credit support requirements at March 2020 levels until they have removed all their temporary vacancy flags from CMOS in accordance with the Code. This formed part of our change proposal CPW101, on which we have published our decision on Thursday 30 July and a separate decision in relation to Credit Support Requirements[4] alongside this decision. In that consultation, Ofwat also sought views on behalf of The Panel on this alternative proposal in relation to Credit Support Requirements, which seeks to reduce the Credit Support Requirements for Retailers who have not deferred any of their Wholesale Charges. The responses to this consultation are discussed below.

The issue

The Proposer does not consider that maintaining Credit Support Requirements at the March 2020 level is reflective of the actual risk to Wholesalers where a Retailer has not opted in to defer payment of Wholesale Charges under CPW093 and/or CPW096. The Proposer has outlined that by maintaining the Credit Support Requirements at March 2020 levels for Retailers that have not opted to defer any Wholesale Charges results in those Retailers posting credit that is equivalent to 50 days of Settlement Charges.

The Proposer has provided information which demonstrates that where a Retailer has not deferred Wholesale Charges, requiring credit support at the March 2020 level is not reflective of risk where payments are not deferred. It is the Proposers view that the P1 Settlement Run remains a valid estimate of likely settlement charges.

The Final Recommendation Report notes that a lagging effect between the P1 and R1 Settlement Runs will arise as sites are moved from vacant to occupied status as businesses re-open. It states that Retailers must adequately prepare for upward step-changes in credit as businesses re-open. The report suggests that the scale of the difference and the impact of any lag will depend on the rate of businesses

[4] We published our decision on CPW101 on Thursday 30 July. That decision related to issues on liquidity, the use of the temporary vacancy flag and Market Performance Framework Charges.

opening and the speed at which this is reflected by Retailers making changes to settlement-data as lockdown measures are relaxed.

The Change Proposal[5]

It is proposed that where Retailers Post-Pay Wholesale Charges and have not deferred payments of Wholesale Charges, they would not be required to retain the credit support at the March 2020 level.

It is proposed that where a Retailer pays its Primary Charges in full, they should benefit from a reduction in the Credit Support Requirement associated with lower P1 settlement values under the standard credit support rules. They would not be expected to retain credit support at the March P1 level.

To achieve this, it is proposed that a new section is inserted into the Business Terms:

"9.12.3 (d) The requirement in Section 9.12.3 (c) shall not apply to a Contracting Retailer who has either never elected for the provisions of Section 29 ("Payment Deferral – Medium Term Measures") to apply, or, at the date of the relevant P1 Settlement Report, whose current Minimum Payment Requirement and Cumulative Outstanding Balance are zero or negative."

Industry consultation and assessment

Following implementation of the temporary Change Proposals to address the short and medium term impacts of Covid-19 on the business retail market, Ofwat consulted from 9-16 July 2020 on next steps in response to Covid-19. Within that consultation we included questions on CPW100.

In response to the questions relating to CPW100, we received submissions from CCW, ten Wholesalers, six Retailers and eight self-suppliers. We have provided an overview of the consultation responses below. A more detailed summary of the consultation responses has been provided with the Final Recommendation Report, and the redacted responses can also be viewed here.

Overview of consultation responses

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

Question A1. What are the benefits and risks associated with implementing different credit support requirements for Retailers who have and have not deferred wholesale charges?

<u>Wholesaler responses</u>

Six out of ten Wholesaler respondents said they did not support differentiation of Retailers that have deferred Wholesale Charges from those that have not.

These respondents supported a change to credit support arrangements for Retailers that have removed all temporary vacancy flags, and which have repaid any deferred payments/not deferred payments. Their view is that the impact of Covid-19 has increased the default risk of every Retailer operating in the business retail market. It was argued that if the arrangements are based on a period when a large number of properties were flagged vacant, the value of guarantees will be distorted and will not reflect the level of credit risk that Wholesalers are being required to bear now that businesses are reopening.

One Wholesaler further stated that whether or not a Retailer chose to defer a proportion of Wholesale Charges had no bearing on their collateral movement; but choosing to flag a property as vacant or reduce its estimated charges via an adjusted YVE did have an impact. It is possible that Retailers who did not defer only did so due to their use of vacant flags and YVE adjustments.

It was argued by another Wholesaler that allowing Credit Support Requirements to be reduced based on current settlement values from CMOS would present additional credit risk for Wholesalers. This Wholesaler would not support a move to credit requirements based on current settlement values until the use of the Covid-19 vacancy flag has passed. Another Wholesaler said there seems to be no reason to alter the terms of credit support to those Retailers who are not deferring payments.

Four Wholesaler respondents considered that Credit Support Requirements should depend on whether the Retailers had deferred Wholesale Charges. It was stated by one that credit support should be provided based on the outstanding balance in order to be consistent between Retailers. One Wholesaler considered that a Retailer who has not deferred Wholesale Charges presents a different risk profile to a Retailer that has and therefore, they can see a logic to support different requirements for each Retailer is this scenario. Another Wholesaler supported CPW100 providing that all temporary vacancy flags had been removed from CMOS first.

<u>Retailer responses</u>

Responses from some Retailers and Self-Suppliers to this question suggested that credit and/or cash are tied up in credit support at a time when this is needed the most. One Retailer said that Retailers' financing capacity might be reduced were credit security to exceed customer receivables or is increased beyond normal levels. This respondent suggested that this reduces financial flexibility and resilience.

A Retailer said there are benefits for Retailers who did not opt to defer Wholesale Charges. However, they said that there is a risk that this could encourage inappropriate use of YVE or temporary vacancy flags to drive down Primary Charges and associated Credit Support Amounts.

Another Retailer respondent said that where a Retailer is not benefitting from any deferral and is still paying all Wholesale Charges in full and on time, it does not seem fair that they should also pay a higher credit support based on figures they do not actually owe. They considered that Retailers in this position are in effect getting a double charge as they are paying charges at the right time but are also having to provide credit support at an elevated level. This respondent stated that ultimately anything that arbitrarily increases the cost of retail service (paying for a higher guarantee than necessary) will eventually be passed on to the customer. They considered that this passes profit out of the business retail market to financial institutions.

A Retailer suggested that the approach proposed by CPW100 would encourage Retailers to find alternative liquidity support as opposed to relying on the market solution. This respondent stated that the distinction between Retailers on this basis is likely to be more 'cost reflective' and better reflect actual credit worthiness, however the respondent thought that this would create an additional relative cost of operation for those Trading Parties that are already struggling.

Another Retailer considered that differing rules for Retailers that have deferred Wholesale Charges and those that have not could result in confusion.

The Self-Supply community said they retain the position that, whether a Trading Party has chosen to defer Wholesale Charges or not, should have no relevance to market wide credit arrangements.

A2. What assumptions are you making about the level and speed of return of NHH water consumption?

<u>Wholesaler responses</u>

- Wholesalers generally see a 20% to 30% reduction in consumption compared to last year;
- One Wholesaler is expecting most business premises to open by September 2020;
- Two Wholesalers expect 2% to 20% residual business failure rate due to covid-19;
- One Wholesaler expected levels of consumption to escalate rapidly post 1 August 2020 as the series of lockdown measures are eased and businesses recommence trading;
- Four Wholesalers estimate a 2% drop to 15% drop in consumption by the end of the financial year, compared to the pre-Covid period; and
- One Wholesaler said it recognises that the position is still relatively dynamic and subject to change. It observed that there were significant levels of businesses re-opening and expected that to continue over the next 2-6 weeks from the date of its consultation response.

Retailer responses

- One Retailer thought that consumption will be back to 90% of what it was pre-Covid by wonder and 10% would disappear for the foreseeable future;
- One Retailer said that there had been a 45% reduction in consumption which they expected to unwind to 25% in July, 10% in September and then 5% in December. This 5% reduction will continue into 2021 to reflect businesses that either do not reopen or operate at a reduced capacity due to lower demand;
- One Retailer said that factors impacting the speed of recovery will be social distancing (if businesses cannot operate at full or near-full capacity it may be uneconomic to continue operating) and consumer confidence (noting that consumer confidence could be impacted by unemployment if this increases by 10%;
- Two Retailers are forecasting an unwind in September 2020;
- One Retailer is assuming there will be a step down of vacant SPIDs from May 2020 to July 2020, followed by an increase from August 2020 to December 2020 due to permanent business closures, which will pick up (due to re-occupancy) from February 2021; and
- Each self-supply license holder has a tailored approach to return to business as usual.

A3. Please explain the makeup of your credit support and levels of Unsecured Credit Allowances in the pro-forma on the following page.

Given the commercially confidential nature of the responses to this question, the data has been anonymised and summarised in two tables which can be viewed in the Final Recommendation Report.

A4. Please tell us how regularly you reduce or increase credit lodged to match falls and rises in the P1 Settlement Report and explain what the associated costs are. Please also clearly state the monthly cost or saving you would expect to incur across your portfolio as a result of maintaining credit equivalent to July P1 vs credit equivalent to March P1 and provide supporting evidence where necessary.

The consultation responses suggested that the impact of any cost saving arising from a reduced Credit Support Requirement varies depending on the type of credit support that is used. For example, Retailer respondents that used a Parent Company Guarantee said that they would not benefit from material savings if CPW100 were to be implemented. However, Retailers that relied on Letters of Credit or surety bonds said that they might achieve savings at differing levels if the Change Proposal were to be implemented. One Retailer stated that any excess credit it is required to maintain reduces its overall funding capacity.

The Proposer’s view on the consultation responses

The Proposer did not agree with the respondents that considered there is no case for treating those who had deferred charges differently from those who had not. The Proposer suggested that there is a confused rationale for maintaining the level of credit support at the March 2020 level. The Proposer contends that neither the Panel nor Ofwat conducted a meaningful impact assessment before implementing CPW095. It should be noted the CPW095 was an Urgent Change Proposal which was raised as such because of the necessity to promptly address an unintended consequence of CPW091.

The Proposer stated that it is the essence of the code that Primary Charges should be calculated based on consumption and it is important that this connection should not be broken. The Proposer does not think that it is efficient for credit support to be based on consumption levels which are ‘out of date’. They have argued that consumption has fallen and they do not consider that consumption will return to previous levels for some time, if ever. The Proposer also highlighted that some Retailers considered that tying up working capital unnecessarily was not in customers’ interests, as the additional costs would ultimately be borne by customers and, conversely, any cost reductions would not be available to be passed through to them. The Proposer does not agree that Retailers should continue to bear the costs of maintaining credit support at the March 2020 level for prudential reasons (i.e. to avoid a fall and later increase in credit support).

The Proposer disagreed with the consultation responses which suggested that higher credit support requirements incentivise Retailers to remove temporary vacancy flags. They suggested that Retailers do not need a penalty to incentivise them to establish consumption and charge customers accordingly. The Proposer also stated that most (but not all) Retailers charge a percentage margin on charges, and benefit from increased Wholesale Charges and increased consumption, provided customer bills are correctly calculated and legally enforceable. The Proposer has outlined constraints on meter reading and argued that there will inevitably be a significant 'overhang of premises' that either remain closed or continue operating at a much reduced capacity. It is suggested that to mark these premises as occupied 'based on the presumption that they are operating normally or near normally, and to base credit support requirements on the same presumption, does not recognise reality'.

The Proposer suggests that the Panel must evidence that calculations of credit support comply with the principles of the codes.

The Proposer's reply to the consultation responses can be found in more detail in the Final Recommendation Report.

Panel recommendation

The Panel considered this Change Proposal at its meeting on 28 July 2020. Seven Panel Members voted that the recommendation to the Authority should be to approve the Change Proposal and five Panel Members voted against it. In line with established Panel voting majorities, a simple majority plus one in favour of the proposal was not achieved and therefore, the recommendation to the Authority is to reject the Change Proposal.

Panel deliberations

One Panel Member that voted against the change thought that the materiality of the risk associated with temporary vacant sites is much greater than materiality of the deferred charges. This is because there is a lack of certainty regarding the extent to which a proportion of the settlement charges that have been reduced through use of the temporary vacancy flag will become payable if it is subsequently identified that the relevant premises were operating. Consequently, they felt it was appropriate for Retailers to continue posting credit at levels equivalent to March 2020 requirements or higher as this would retain a protection for customers should a Retailer default. A number of Panel Members agreed with these considerations and concluded that the proposed change was therefore not better when considered against the current code baseline.

Another Panel Member, that had preference for the credit support proposals that were included in CPW101, also felt that deferred Primary Charges increased the indebtedness of Retailers and the potential impact associated with Retailer payment default. This Panel Member suggested that this, in turn, exposed customers to a higher degree of risk. They recommended that Ofwat should consider carefully the prospect of a layered approach which requires Retailers to maintain credit support at a level at least equivalent to the March 2020 P1 Settlement Run if they had either deferred Primary Charges or if they had any temporary vacancy flags for Settlement Periods from 1 August 2020 onwards.

A Panel Member felt that a layered approach should not be taken. They highlighted that both Wholesalers and Retailers that responded to the consultation felt that it was unlikely consumption would return to ‘pre-Covid’ levels by the end of the year. Therefore, they concluded that it was inappropriate to require credit be lodged at ‘pre-Covid’ levels as this would result in additional complexity when unwinding the Credit Support Requirements.

One Panel Member recognised the difference in the risk profile across Retailers, particularly between those that had deferred and those that had not and those that had differing levels of temporary vacant supply points. In particular, Retailers not deferring have a lower risk and should have a lower Credit Support Requirement. This Panel Member said that Retailers using the deferral mechanism have a higher risk and should have a higher collateral requirement. They queried whether it would be possible to recognise this difference in some way, suggesting a blended approach that might require maintenance of Credit Support Requirement at some level between that defined by the current monthly P1 Settlement Runs and that defined by the March 2020 P1 Settlement Run.

The Panel requested that Ofwat take great care in considering which approach to Credit Support Requirements is appropriate.

View of the Customer Representative Panel Member

The Customer Representative Panel Member said that as the change to Credit Support Requirements is temporary, they wanted to see further evidence relating to what this means for Retailers and the knock on effect to their customers.

Our decision

We have considered the issues raised by the Change Proposal and the supporting documentation provided in the Panel’s Final Report and have decided to reject this Change Proposal.

We acknowledge the concerns raised by the Proposer and understand the rationale behind the Change Proposal. We recognise that there is a need for unwinding of the current Credit Support Requirements as new ‘normal’ levels of consumption start to become apparent and we do not want to tie up capital unnecessarily.

After reflecting on the evidence received through the consultation responses, we subsequently proposed (as part of CPW101) amendments to the Credit Support Requirements. Our proposal was that all Retailers will be required to maintain Credit Support Requirements at March 2020 levels until they have removed all their temporary vacancy flags from CMOS in accordance with the code. Those that do so will then go back to being subject to standard Credit Support Requirements which are calculated based on Settlement Reports. The first Invoice Period for which a Retailer can qualify to return to standard credit support requirements is October 2020. It is not a requirement that all temporary vacancy flags in the market as a whole to be removed before standard Credit Support Requirements apply to an individual Retailer, or for that Retailer to have repaid all outstanding deferred Wholesale Charges.

We have considered which approach to Credit Support Requirements is the most appropriate to take in these circumstances: linking Credit Support Requirements to temporary vacant supply points or deferred Wholesale Charges. We acknowledge the Proposer’s rationale for CPW100. However, as the Proposer has highlighted, the current use of temporary vacancy flags and amended YVEs are having a significant impact on settlement values. The Market Auditor has highlighted that there is a high likelihood of under and over-stated positions on temporary vacancy flags as we enter the unwinding phase. If Credit Support Requirements were to be set based on current Settlement Reports, there is a risk that Retailers might not be posting the appropriate amount of credit (for example if there are lags in removing the temporary vacancy flags from CMOS), regardless of whether or not they have opted in to defer Wholesale Charges. This has the potential to increase Wholesaler risk and also the potential to negatively affect customers, in the event of an unplanned Retailer exit.

We also think it is important to incentivise a measured and timely removal of temporary vacancy flags in the market given their potential impact on consumption levels and settlement values in the market and we note the Panel’s support for this rationale. We therefore disagree with the proposal that a return to March 2020 credit arrangements should be conditional on the Retailer having no outstanding deferred amounts under the deferral scheme, including because this would dampen the incentive to transition out of Covid vacancy arrangements for those Retailers who have opted into the deferral scheme. Whilst we agree that the deferral of Wholesale Charges also increases Wholesaler risk, we have already capped the increased exposure that Wholesalers bear from the liquidity arrangements we have put in place, to the average monthly charge for the failed Retailer. Whilst we acknowledge that the Proposer does not agree, our view is that it is important for prudential reasons, to protect Retailers from encountering a cliff-face in the provision of credit support when vacant flags are switched off and consumption begins to rise. If Retailers were to encounter a significant and sudden increase in the Credit Support Requirement they could possibly face difficulties in securing the appropriate amount of credit support at very short notice, which could have an adverse effect on customers. Therefore, we consider that using the current Settlement Reports to calculate the Credit Support Requirement, where Retailers have not removed all their temporary vacancy flags, is not in the best interests of customers or the market as a whole.

Following implementation of CPW101, Retailers will be able to return to Credit Support Requirements based on current Settlement Reports once they have removed all their temporary vacancy flags. Retailers are able to take actual Meter Reads or where this is not possible, they can proactively engage with their customers and subsequently enter more accurate YVEs into CMOS. To be clear, we do not expect Retailers to enter arbitrarily low YVEs simply as a means to accessing lower credit support requirements once they have removed their temporary vacancy flags. We will work with MOSL to monitor this and will take appropriate action if this is found to be the case. As stated in our decision document on CPW101, we will work closely with MOSL to update guidance and provide clarity on the evidential requirements for using YVEs. We are also minded to introduce an incentive this autumn to monitor inappropriate use of YVEs to encourage more accurate consumption data in the market. This should help ensure that settlement calculations are more accurate for those customers whose consumption continues to be lower than prior to Covid-19.

We have approved CPW101 as opposed to CPW100 because we remain of the view that the reduction in credit support requirements was an unintended consequence associated with allowing Retailers to use the temporary vacancy flag (CPW091). CPW101 enables a Retailer to have its credit support requirements based on settlement values once it has removed all of it temporary vacancy flags, which also provides an additional incentive for the measured and timely removal of these flags. This should help to achieve better outcomes for customers as it should lead to more accurate consumption data in CMOS. We consider that implementation of CPW101, alongside our previous decision to cap the increased exposure that Wholesalers bear from the liquidity arrangements we have put in place, provides an appropriate balance of risk and enables changes to the Credit Support Requirements to adapt to reflect the new ‘normal’ levels of consumption following removal of the temporary vacancy flag. We consider that CPW101 better furthers the objectives and principles of the WRC than the proposed amendment under CPW100. We have therefore decided to reject CPW100.

Decision notice

In accordance with paragraph 6.3.7 of the Market Arrangements Code, the Authority rejects this Change Proposal.

Georgina Mills
Director, Business Retail Market