
Wholesale Retail Code Change Proposal – Ref CPW061

Modification proposal	CPW061 – Unsecured Credit Allowance reflecting payment history
Decision	The Authority has decided to reject the Change Proposal
Publication date	27 November 2020
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 to improve the effectiveness of the credit arrangements with a particular focus on small new entrants, including to review 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 Wholesale Retail Code (“**WRC**”) currently provides that Retailers can access an Unsecured Credit Allowance (“UCA”) using the following options:

- Current Credit Rating;
- Current Credit Score; or
- Trade Credit Insurance.

The issue

A Change Proposal was developed by a committee 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, would find it difficult to obtain a credit score or rating with which to access an UCA with a Wholesaler. It was suggested that new entrants could access an UCA on the basis of strong payment histories (“**Payment Performance UCA**”) in lieu of credit ratings and scores.

This Change Proposal was originally recommended to Ofwat by the Panel in May 2019. At the time, Ofwat was unable to properly form an opinion on that Change Proposal based on the information and evidence provided. Ofwat therefore requested that prior to the Change Proposal being resubmitted to Panel, the original Final Report be reconsidered and a revised recommendation provided that specifically addresses concerns around:

- The lack of rationale to support the proposal that a Payment Performance UCA should be available to all Retailers given that some will have been operating in the market for a sufficient time to rely on the other UCA options in the WRC;
- Whether the proposal of monitoring of payment performance within individual wholesale Areas is sufficient as this does not provide a full picture of a Retailer’s payment history;
- The cumulative application of Payment Performance UCA along with existing UCAs provided for in the WRC up to a maximum of 40%. Specifically, we had reservations about the cumulative application with Trade Credit Insurance, given the proposal was to monitor performance at individual wholesale Areas; and
- The automatic reversion to 0% Payment Performance UCA following one non-payment could potentially have an adverse impact on Retailers’ ability to continue to operate in specific wholesale Areas and could be detrimental to customers.

Industry consultation and assessment

Since the previous Change Proposal was submitted there has been no further industry consultation. For information, the analysis of responses to the original consultation in March 2019 can be found in [the initial Change Proposal here](#).

The modified Change Proposal¹

The Credit Committee have since considered the feedback from Ofwat and developed two revised solutions for CPW061 – a proposed solution and an alternative solution.

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>

i) Proposed solution

UCA for good payment performance

The UCA available under the proposed solution would be based on Payment Performance, and would amount to 10% six Months after market entry and 20% 12 Months after market entry. Existing Retailers would be permitted to use their previous payment performance. It requires the full payment of Primary Charges as well as the provision and maintenance of Credit Support Balances and Credit Support Amounts by the due date in accordance with Section 9 of the Business Terms.

Withdrawal of UCA and cure period in the event of late payment

Where payment of charges and/or credit support amounts have not been made in full and on time in any given month, then the UCA shall revert to 0%, save that a Retailer shall be permitted the ability to “cure” the non-payment of charges and/or Credit Support Amounts or Credit Support Balances on one occasion in each rolling six-Month period, by making the necessary payment or providing the requisite credit support within a further period of five Business Days. This creates an incentive to maintain good payment performance but allows for periodic non-material issues to be managed pragmatically without automatically losing access to the Payment Performance UCA. For clarity, the inclusion of the cure period does not affect the timescales under which a Retailer can go into default.

Access to UCA for good payment performance

We asked the Panel to consider whether Payment Performance UCA would be available to all Retailers, or whether this would be available for a shorter timeframe after market entry in the same way as, for example, access to UCA by using Trade Credit Insurance which can only be used for a period of three years following market entry. The proposed solution does not place any time limit on access to Payment Performance UCA. The revised Final Report states that this is to ensure consistent and non-discriminatory access to this UCA. Current Retailers would be able to use their existing payment history with a Wholesaler at the date of implementation to access Payment Performance UCA.

Cumulative application of Payment Performance UCA with other forms of UCA

The Payment Performance UCA would be accessed cumulatively with the UCA available under existing provisions of the WRC where Retailers can use either a

Current Credit Score or Trade Credit Insurance to access UCA, subject to a maximum combined UCA of 40%.

Central monitoring of Payment Performance

The Credit Committee agreed that it was not necessary to monitor payment performance across wholesale Areas on a multilateral basis following the implementation of this scheme, as this would be inconsistent with the bilateral way in which the market operates.

ii) Alternative solution

The alternative solution is identical to the proposed solution, apart from the provision for the Payment Performance UCA to be accessed cumulatively with a UCA obtained via a Current Credit Score or Trade Credit Insurance. The alternative solution proposes that Payment Performance UCA is not to be applied cumulatively with any other forms of UCA and serves only as an alternative way for Retailers to gain access to a UCA with a Wholesaler. This is consistent with the current approach in the WRC, whereby each UCA option stands alone and cannot be used in conjunction with any other.

This would mean that all Retailers could benefit from a UCA of up to 10% after six Months of good payment performance and 20% after 12 Months of good payment performance. However, once a Retailer has sufficient credit history and accounts information to be in a position to access a UCA based on a Current Credit Score or Current Credit Rating, it may do so. Alternatively, these Retailers could continue to access a UCA based on continued good payment performance instead.

Panel recommendation

Vote on proposed solution vs alternative solution

Seven Panel Members voted in favour of recommending the proposed solution to the Authority for approval, based on the arguments as set out in Section 5 of the revised Final Report and discussed further in our decision below. Three Panel Members voted in favour of the alternative solution; one doing so for the reasons outlined in the paragraph below, another on the basis that the arguments in favour of the proposed solution were insufficient to refute Ofwat's concerns, and the third because they saw no evidence to suggest that a cumulative Payment Performance UCA option would provide a greater customer benefit than a non-cumulative Payment Performance UCA option.

As a result, the Panel recommendation is for the Authority to approve the proposed solution to CPW061.

Vote on whether the proposed and alternative solutions further the Principles and Objectives of the WRC

The Panel agreed that the proposed solution would better facilitate the WRC Objectives and Principles (11 votes in favour, one vote against) and that the alternative solution would also better facilitate the WRC Objectives and Principles (unanimous). The revised Final Report states that the Panel Member who voted against the proposed solution considered that “the proposed solution would grant significant credit reductions to established Retailers without the need for them to make any change in their payment behaviour, performance and risk profile”. Their view was that the provision to achieve a 40% UCA through the cumulative application of Payment Performance UCA would introduce an incentive for timely payment (which is not the principal aim of CPW061 nor a key market need) and could also allow larger established Retailers to pick and choose where to optimise their financial position when experiencing cash flow difficulties. The Panel Member suggested that the alternative solution would achieve the intended and proportionate benefits for new and smaller Retailers without any of these adverse effects.

Implementation date

The Panel recommended an implementation date of the 1st of the Month but at least 15 Business Days after Ofwat approval and subject to Ofwat having determined that the Covid-19 pandemic has been substantially resolved.

Our decision

We have carefully considered the issues raised by the Change Proposal and the supporting documentation provided in the Panel’s revised Final Report, and have concluded that the implementation of CPW061 will not better facilitate the principles and objectives of the WRC. As such Ofwat has decided to reject this Change Proposal.

We agree with the concept on which the Change Proposal was based, insofar as we are keen to remove any actual or perceived barriers for new entrant Retailers. However, we have concerns about both the proposed and alternative solutions provided, how they address the issue and the evidential basis for them, which has resulted in the conclusion to reject this Change Proposal. Our concerns are explained in more detail below.

We are not convinced by the arguments set out that the proposed or alternative solution addresses the primary issue identified by KPMG, namely that ‘small new entrant Retailers without a credit history to obtain a credit score or credit rating with which to access a UCA with a Wholesaler might [be] discouraged ...from entering the market’.

Further, we do not consider that the Final Recommendation Report provides sufficient evidence to address our previous concerns, particularly in relation to cumulative access to UCAs. We do not consider that the rationale provided adequately supports the proposal for payment performance to be available to all Retailers or the proposal for payment performance monitoring, in either the proposed or alternative solutions. Further, we believe that these factors combined could create undue risk exposure to Wholesalers (and customers²) which has not considered.

Reasons for our decision

Cumulative access to UCAs

The proposed solution does not address our concerns about the cumulative application of Payment Performance UCA with other types of UCA which we outlined in our previous decision document on this Change Proposal.

Whilst we acknowledge that the alternative solution presented removed the option for cumulative application of Payment Performance UCA with other forms of UCA, it is clear that the Panel did not favour this option, voting instead to recommend (by majority) the proposed solution as it was seen to encourage new entrants to the market, provide improved competition and an enhanced level playing field. Our other concerns with the alternative proposal are included in the reasons for our decision below.

Availability of Payment Performance UCA for all Retailers

When we returned the original proposal to the Panel, we asked for rationale to be provided to support the proposal that Payment Performance UCA should be available to all Retailers, particularly given that some will have been operating in the market for a sufficient time to rely on the existing provisions in the WRC on which to access a UCA.

² Wholesalers are likely to incur bad debt costs in the event of an unplanned Retailer exit, some of which will be passed on to customers (e.g. through the totex sharing factors).

The Final Report notes that existing market participants would possibly gain a marginal additional benefit because they would be able to rely on existing payment history to access a Payment Performance UCA, and for the proposed option, would be able to apply this cumulatively with other options. It is stated that to prevent existing market participants from using existing payment history would essentially require the Payment Performance UCA accrued by any Retailer to be wiped whenever a new Retailer entered the market in order to maintain a level playing field. No explanation was provided to support this opinion.

The Credit Committee obtained legal advice on whether Payment Performance UCA should be open to all Retailers. The Final Report summarised the advice provided, as *'[t]he Credit Committee obtained legal advice on the matter ... which confirmed that a decision to limit access to P[ayment] P[erformance] UCA would be construed as applying dissimilar conditions to equivalent transactions with Trading Parties across the market, which would be in breach of Section 18(1) of the Competition Act 1998'*. The advice was separately provided, in confidence, to Ofwat. We consider that the summary of legal advice obtained included in the Final Report is not an accurate representation of the advice provided to the Credit Committee, and which Ofwat has seen. When looking at the summary and the advice in conjunction with one another, we consider that the summary has overstated the outcome of applying dissimilar conditions when considering Competition Law.

Further, it also suggested that excluding certain Retailers from the Payment Performance UCA would be inconsistent with the market principle of non-discrimination, and It would be inappropriate to recognise payment performance as a good indicator of creditworthiness only for a subset of Retailers. The explanation provided is that some Retailers have highlighted a difficulty in accessing and maintaining a UCA through the current means, citing specifically difficulties in achieving a qualifying Current Credit Score. Neither of the solutions presented address concerns that credit reductions will be granted to Retailers without sufficient change in behaviours and risk profile. The potential impact on Wholesalers (and customers) of this change does not appear to have been considered by the Credit Committee. In any case, the principle of non-discrimination is to ensure that arrangements established by or under the Wholesale Contract should not unduly discriminate, or create undue discrimination. This principle does not require that all Retailers should have, for example, access to all types of credit offerings – they may not meet the requisite criteria. Wholesalers are able to differentiate their credit offerings to Retailers under Schedule 3 of the Business Terms, provided that any differentiation is objectively justified.

In response to our suggestion that consideration should be given to a time limited approach, the Final Report states that there is not enough track record within the market to reliably conclude that three years is a sufficient timescale for Retailers to obtain and rely upon a UCA through existing provisions. The Final Report states that some Retailers have indicated that they have experienced difficulties in obtaining UCA using some of the current options, for example because of “the restriction of net worth in achieving a qualifying Current Credit Rating, or because Current Credit Scores have been demonstrated to fluctuate regardless of relatively stable finances”.

Monitoring Payment Performance across individual wholesale Areas

We had stated in our previous decision that we had concerns that monitoring of Payment Performance in individual wholesale Areas might not provide a full picture of a Retailer’s payment history and therefore asked whether this would be a reliable measure of credit risk in lieu of the other options. We also questioned whether, if a Retailer is experiencing financial difficulties, it may be incentivised to target its payments in wholesale Areas where Payment Performance UCA is most valuable to them, so as not to lose it.

The Credit Committee considered that if payment history were to be shared between Wholesalers this could present a legal risk to MOSL or a credit scoring agency where a Wholesaler shared such commercially sensitive information with its Associated Retailer. We note the legal advice obtained by the Credit Committee, and the suggestions included within that advice. The Final Report does not detail the Credit Committee’s consideration of the legal advice or any further assessment carried out in light of it, which we consider would have been beneficial. Separate to this advice and in response to this concern we note that licence conditions exist that create ring-fencing provisions to, for example, prevent anti-competitive behaviour. Any evidence of a breach of licence conditions should be presented to Ofwat for investigation.

The Panel stated that their view is that a Retailer would not achieve benefit in targeting payments in particular wholesale Areas and that there was no evidence to suggest that this was a market concern following analysis of non-payment which indicated that just 0.9% of invoices over a three-month period, between September 2019 and December 2019 were not paid by the invoice due date. The Panel also stated that Wholesalers are already monitoring monthly credit support levels and can monitor bilateral settlement performance simultaneously.

We acknowledge the arguments put forward in the revised Final Report, in particular relating to the analysis of non-payment which suggests that levels of

non-payment across the three-month period were low. However, the introduction of payment performance could create stronger incentives in the future for Retailers to target their payments in wholesale Areas where it is most valuable to them, which would not be visible from any market data prior to the introduction of the change. Furthermore we do not yet know the extent to which payment performance may be impacted by Covid-19. These issues have contributed to our decision to reject this Change Proposal as we do not consider that sufficient consideration has been given to:

- whether there could have been an obligation on Retailers to inform Wholesalers which they have a Wholesale Contract with where they have missed payments in other Areas, similar to the requirements set out in the Business Terms for the downgrading of a Current Credit Score and Current Credit Rating, including consideration of the codification of the procedure for the removal or reduction of the Payment Performance UCA in these circumstances; or
- how the monthly credit support levels and bilateral settlement performance monitoring could have been used by Wholesalers to challenge the viability of a Payment Performance UCA in their Area, again including consideration of the codification of the procedure for the removal or reduction of the Payment Performance UCA in these circumstances.

Impacts of Covid-19

The Panel made its recommendation on this Change Proposal at its meeting on 31 March at which point the impacts of Covid-19 were only beginning to materialise. Working closely with MOSL and industry we introduced a series of measures to protect business customers in light of Covid-19, including the ability for retailers to defer payment of a proportion of Wholesale Charges due. Where Retailers have deferred payment of Wholesale Charges, these are due to be repaid in full by end March 2021. We also set a cap³ on the additional exposure that each Wholesaler will face as a result of providing liquidity to each Retailer that covers part - but not all - of the additional risk Wholesalers face from the Covid-19 liquidity measures introduced. Given that a number of Retailers chose to defer payment of a proportion of their Wholesale Charges, we remain concerned that both the proposed and alternative solutions could

³ On a Retailer failing, the bad debt the Wholesaler will carry, after the price control sharing factor has been applied, will be capped at the £m figure equivalent to the average monthly Wholesale Charge for that Retailer. See our decision documents [here](#) and [here](#) for more information.

expose Wholesalers (and customers) to further risk that has not been considered in developing this Change Proposal.

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