Wholesale Retail Code Change Proposal – Ref CPW086

Modification proposal	CPW086 – Unsecured Credit Allowance - Rebalancing
Decision	Ofwat has decided to reject this change proposal
Publication date	27 November 2020
Implementation date	N/A

Background

The Wholesale Retail Code (WRC) Schedule 1 Part 2: Business Terms (Section 9.11) sets out the Credit Support Requirements for Retailers who select Post-Payment of Primary Charges. One of the ways in which Retailers are able to meet their Credit Support Requirements is through the use of an Unsecured Credit Allowance (UCA).

Following the receipt of each P1 Settlement Report, the Contracting Retailer is required to provide the 'Credit Support Amount' (CSA) for the following Invoice Period. The CSA is the Credit Support Requirement for the following Invoice Period, less any applicable UCA and any accrued interest from cash deposited by the Contracting Retailer in the Cash Security Account.

Schedule 2E of the Business Terms sets out the terms upon which a UCA must be made available by the Contracting Wholesaler to the Contracting Retailer in relation to the CSA. A summary of the UCA levels available to Retailers depending on their credit rating, credit score or access to Trade Credit Insurance is replicated in Table 1 below.

Type of evidence	Level of Unsecured Credit Allowance
Current Credit Rating meets the Minimum Credit Rating or above	40%
Current Credit Score is 9 or 10	20%
Current Credit Score is 7 or 8	10%

Self-certification of Trade Credit Insurance is greater than 90%	20%
Self-certification of Trade Credit Insurance is 90% - 70%	10%

The issue

This Change Proposal has been submitted by Castle Water and sets out two key issues that it is seeking to address:

Issue 1

It stated that where Section 9.11 of the Business Terms provides for Current Credit Scores to be treated as alternatives to the Current Credit Ratings, the underlying principle is that there is a correlation between the two and that the gap between the levels of UCA available for both is too wide.

The Proposal describes the different functions of credit ratings and credit scores and states that a credit rating primarily indicates the holder's ability to finance its long-term corporate debt and bondholder obligations. It argues that as seniority for repayment of long-term secured debts is higher than for short-term unsecured debts, a strong corporate credit rating (for long-term debt) cannot be implied to indicate a strong rating for unsecured creditors. Consequently, the credit rating used under the terms of the codes will only indicate the maximum degree of credit security, which may overstate the real level of credit security to a trade creditor. A credit score is therefore a truer indicator of the holder's ability to meet the demands of unsecured creditors through the strength of its balance sheet.

Issue 2

It is the view of the proposer that it is impossible for an independent Retailer to obtain a Minimum Credit Rating as an alternative to a credit score. The weight given to scale in the credit metrics of Credit Rating Agencies (for example Moody's) means that such a rating cannot be gained by companies unless they have a turnover that is likely to be significantly higher than most of the current participants in the market. The proposer views that this is contradictory to the principles of the code.

The proposal sets out that while the maximum credit assessment score merits a 20% UCA as above, a Minimum Credit Rating merits a 40% allowance. The maximum possible UCA for a smaller company is therefore purported to be half of that available to a larger company, irrespective of their relative financial strengths. As a result, the Proposer suggests that Associated Retailers have access to lower capital costs than independent Retailers, even when they have lower credit metrics.

The Proposer contends that, in competition law terms, these factors would constitute grounds for undue discrimination because:

(a) the gulf in the treatment of the two groups is simply too wide in absolute terms

- To treat a maximum credit score less favourably than a minimum credit rating by 20% creates a significant difference in cost of financing.

(b) it is without any objective justification and hence arbitrary

- There is no objective reason for affording more favourable treatment to a company that is able to acquire a credit rating through group association, including historic scale, access to finance and parent company guarantees, whilst raising the financing costs of those relying on credit scores, and creating an artificial barrier to entry and expansion.

- To an independent Retailer, the provision of credit relates to its overall balance sheet capacity and is equivalent to cash. The facilities it uses to provide credit support can also be used to make cash payments. However, for a vertically integrated group provision of credit support is an inter-company transfer. This results in a further distortion of the market in favour of vertically integrated companies.

The Change Proposal[1]

It is proposed that a credit assessment score of 10 should be treated as equivalent to a Minimum Credit Rating (Baa3/BBB-) for the purpose of accessing an equivalent UCA of 40%.

With reference to the scoring bands used by Experian, the proposal noted that the lower credit assessment score bands are in ten-point steps while the two

[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

top bands are in five-point steps (90-94 and 95-100 respectively), suggesting that further granularity could easily be recognised. The Change Proposal sought to treat only the very top band (Band 10) as equivalent to a Minimum Credit Rating.

Industry consultation and assessment

The consultation on CPW086 ran from 18 February 2020 to 3 March 2020. It received 24 responses: 10 Wholesalers, 13 Retailers, and the Customer Representative (the Consumer Council for Water, CCW). Full details of the consultation were included alongside the panels Final Recommendation Report and can be found here.

The consultation responses showed support for this Change Proposal from Retailers, while the responses showed that Wholesalers and CCW are, on the whole, against the proposed changes. The below sets out the key points raised in the consultation.

Question 1: Do you agree that a Retailer who's Current Credit Score is 10 should be given a UCA of 40%? Please explain your answer and provide evidence to support your response where you can.

Agreed (0 Wholesalers, 12 Retailers, 0 Other)

The key arguments to support agreement with this question included:

- There is an imbalance between the treatment of credit ratings and credit scores
- It is viewed as anti-competitive to offer a level of UCA that is only available to some Retailers who have credit ratings and not to others when credit ratings are not determined by the financial strength of a Retailer.
- The maximum possible UCA of 40% should actually be higher due to the low underlying risk that credit worthy Retailers pose.
- The proposed change is an evolution of the credit arrangements in a maturing market and that allowing access to 40% UCA with a credit score of 10 will reduce the costs of collateral for Retailers.
- The risk of a Retailer defaulting with a credit score of 10 is relatively low and therefore the provision of 40% UCA is appropriate.

Disagreed (10 Wholesalers, 1 Retailer, 1 other)

Those who disagreed with this question set out the following arguments in response:

- Credit ratings look both forward and backwards thereby accounting for the likelihood of businesses defaulting whereas credit scores focus only on the prior credit history to evaluate risk
- Credit ratings give a better level of assurance with organisations being assessed and scrutinised to a greater extent
- The cost of gaining and maintaining credit ratings and the potential reputational damage from a downgrading or loss of credit rating gives a greater level of assurance
- Insufficient evidence was provided to demonstrate that Retailers with a credit score of 9 or 10 provide the same level of risk as those with a Minimum Credit Rating
- The equivalency of credit scores and ratings were looked at extensively pre-market opening in 2016, were subject to significant consultation and insufficient evidence has been provided to suggest that this position needs to be changed
- As the impact of this change would be material, it should be considered by the Credit Committee which has not happened up to this point.

Question 2: Does the current UCA present a “discriminatory” barrier to the level playing field for Unassociated Retailers? Please explain your answer and provide evidence to support your response where you can.

Agreed (0 Wholesalers, 10 Retailers, 0 other)

In the consultation responses the key arguments in agreement with this question are:

- It is impossible for an independent Retailer to get a Minimum Credit Rating because of the scale of the metrics and requirements
- Credit ratings can actually overstate the credit worthiness of a business as they are focussed more on a company's funding structure rather than its financial strength. Credit cover requirements are based on distortive effects of scale, market association and the resources of Retailers and that this is detrimental to competition in the market.

Disagreed (10 Wholesalers, 3 Retailers, 1 other)

The key issues raised by those disagreeing with this question are:

- Only Self-Supply Retailers are practically able to access 40% UCA as the Retailer itself must hold the rating not its parent company, therefore it negates any perception of a lack of level playing field
- A number of Wholesalers suggested that un-associated Retailers can obtain a UCA proportionate to their level of business risk and that when barriers to entry and level playing field are considered, this should be on the basis of considering businesses on a "like for like" basis
- One Wholesaler suggested that the fact Retailers may pay different rates for credit is consistent with a competitive market. Some Retailers will therefore have a cost advantage over others and this is not, in and of itself, a concern. Alternative bespoke arrangements for individual Retailers are in place in some instances.
- One Wholesaler believed that the levels of credit made available in the WRC when initially determined by Ofwat demonstrate equivalence to the already established in the electricity industry, under the Distribution Connection and Use of System Agreement (DCUSA) arrangements. They also stated that all Retailers can request their own Alternative Eligible Credit Agreements with Wholesalers; negating risk of a "discriminatory" barrier. They state that there are several Wholesalers offering additional unsecured credit to Retailers without the requirement to lodge additional collateral.

Panel recommendation

The Panel considered this change at its meeting on 31 March 2020 and determined that CPW086 should be recommended for rejection. Three panel members voted in favour, two voted against and seven abstained.

Two Panel members that voted against CPW0086 on the basis that there was no evidence that Retailers were being discriminated against and there was insufficient evidence that the equivalence of credit ratings and scores was causing sufficient harm to justify the proposed remedy. One Panel member further felt that given the proposal had not been considered by the Credit Committee, any changes to credit arrangements made on a piece meal and narrow technical basis risk missing overall balance that the market needs to function effectively. They considered that the solution was not proportionate as it would provide a larger credit facility to existing Retailers without them having to do anything different.

Of the seven Panel members that voted to abstain, many supported the principle of the proposed change but abstained on the grounds of inadequate technical evidence for increasing the UCA available for a credit score of 10. Two of the Panel members acknowledged that access to higher credit is a market issue, but the proposal did not provide sufficient evidence on how the proposed calibration of the UCA would help the market. One Panel member said that they would support a more level playing field, but that CPW086 has not provided the technical basis on why UCA should be increased for the top credit score. Two Panel members said that they would like more legal justifications on whether the current difference in UCAs is a Competition Act issue.

Our decision

We have carefully 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.

Reasons for our decision

We agree with some Panel Member’s views that there is a lack of evidence to support this change proposal, and in particular insufficient evidence to support the proposal that a credit score is a truer indicator of a company’s ability to meet its future obligations. The proposal does not provide sufficient evidence that credit scores provide an equivalent indicator of future credit worthiness and financial stability as credit ratings.

It is our view that credit scores are primarily backward looking. They are offered by a number of organisations that may have differing criteria to generate the scores and therefore can be variable. Credit scores are also likely to fluctuate more often dependant on a Retailer’s circumstances. Credit ratings are based on detailed assessments from the ratings agencies and take into account a far greater number of considerations including past, present and future data. They provide a more accurate picture of an organisations ability to maintain their financial obligations and as such they are a more accurate representation of that organisation's credit worthiness. It is our view that the level of UCA available to organisations with credit ratings versus those with credit scores could be seen to be appropriate given the reasons stated.

In our view the proposal does not provide sufficient evidence that a credit score of 10 warrants a UCA of 40%. Allowing an extra 20% UCA based on a credit score of 10 could therefore increase the level of exposure both to Wholesalers and customers.[2]

The final recommendation report did not provide sufficient evidence to demonstrate that offering UCA of 40% only to those able to obtain a credit rating was anti-competitive and there was nothing in the final recommendation report that allowed us to determine that this is providing a barrier to new market entrants. This was supported by views raised in responses to the consultation which stated that currently it is likely that only Self-Supply Retailers are practically able to access 40% UCA (as the Retailer itself must hold the rating and not its parent company).

We also note that bespoke credit arrangements can be negotiated between Retailers and Wholesalers in accordance with Schedule 3 of the Business Terms, enabling Trading Parties the ability to agree credit terms to reflect the specific characteristics of the Retailer and its risk profile. We set out our view as part of our Review of Incumbent Support for Effective Markets that Wholesalers are able to differentiate their credit offerings under Schedule 3 between Retailers, as long as such differentiation is justified. We think that this provides Wholesalers and Retailers with the opportunity to agree bespoke credit terms appropriate for their individual circumstances, which may include provision for a greater Unsecured Credit Allowance.

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

[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).