
Wholesale Retail Code Change Proposal – Ref CPW115

Modification proposal	Wholesale Retail Code Change Proposal – CPW115 – Amending and updating the definition of Insolvency Event to remove the ‘negative net assets’ criterion.
Decision	The Authority has decided to reject this Change Proposal
Publication date	30 March 2021
Implementation date	N/A

Background

Section 10, Default, of the Business Terms of the Wholesaler Retail Code (WRC)¹ sets out the provisions in which a Retailer may be classed as a Defaulting Trading Party. One of these provisions is where the Retailer is subject to an Insolvency Event, as defined in Schedule 1, Part 1, Objectives, Principles and Definitions of the WRC. Where a Retailer is classed as a Defaulting Trading Party because it is subject to an Insolvency Event, the Wholesaler may;

- (a) enforce its rights under various credit support arrangements in accordance with section 9.14 of the Business Terms;
- (b) terminate its Wholesale Contract with the Retailer, having given requisite notice under section 11 of the Business Terms; and
- (c) remove the Retailer’s right to submit Transfer Registration Applications or request New Supply Points in their Area under section 11.3.1 of the Business Terms.

Sections 122 and 123 of the Insolvency Act 1986 (the ‘IA86’) set out the circumstances in which a company is deemed unable to pay its debts. These include:

- Section 123 (1)(e) if it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due; and

¹ Unless otherwise specified, the terms used in this document are those defined in the WRC

- Section 123(2) if it is proved to the satisfaction of the court that the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities.

The definition of Insolvency Event in the WRC largely mirrors the IA86 and explicitly references section 123 IA86. However, the definition specifically excludes, at sub-section (i)(c), the court's role as provided in section 123(1)(e) of the IA86 by including the words 'it is proved to the satisfaction of the court that in section 123(1)(e) of the Insolvency Act 1986 shall not apply'. Furthermore, where part (vi) of the definition largely replicates section 123(2) IA86, it excludes the requirement that this must be proved to the satisfaction of the court.

The issue

The Proposer² considers that the omissions as to the court's role within the definition of Insolvency Event means that it is inconsistent with the IA86. By the current operation of the WRC, any Retailer reporting negative net assets can automatically be classed as insolvent and consequentially as a Defaulting Trading Party by reference to section 10.1.13 of the Business Terms. This applies regardless of whether or not they are otherwise meeting their contractual obligations. The Proposer states that due to the imminent filing of accounts associated with the financial year ending 31 March 2021, the current situation poses an imminent risk to market stability.

The Proposer considers that the likelihood of market disruption materialising is low as it does not automatically follow that a company with negative net assets will become 'genuinely' insolvent. However, should Wholesalers decide to take widespread action and terminate contracts on this basis (prior to any court process, or prior to a Retailer being classed as a Defaulting Trading Party under another default condition such as late payment), the Proposer considers market disruption may occur through:

- Retailers' contracts being terminated regardless of the relevant Retailer otherwise being a going concern;
- Customers being transferred to other Retailers under the Interim Supplier Allocation Process;
- Interim suppliers encountering short term liquidity, resourcing, and customer satisfaction issues as they attempt to on-board the transferred customers;
- Potential risks associated with customers credit balances being impacted/lost;
- Retailers experiencing difficulties in obtaining credit/financing where investors perceive a disproportionate risk arising from the ability for Wholesale Contracts

² As defined in the Market Arrangements Code

to be terminated on grounds that are over and above those prescribed in the IA86 (in turn increasing the risk of Retailer defaults in relation to credit or similar);

- Retailers may be prevented from taking on more Supply Points in the Contracting Wholesaler's Area, regardless of the Retailer only being "insolvent" by virtue of its negative net assets and otherwise being a going concern. Should this situation become widespread, there is potential for switching to be effectively eliminated from the market, in turn reducing choice for customers.

The Change Proposal³

The solution proposed seeks to align the definition of Insolvency Event in the WRC more closely with the IA86 and thereby remove the ability for Wholesalers to terminate the Wholesale Contract with Retailers on the grounds of negative net assets and without providing proof to the court. Other reasons for default and termination (e.g. late payment of primary charges or failure to maintain the required credit balance) would be unaffected by this change.

The intention of CPW115 would be delivered through two amendments to the definition of Insolvency Event in WRC Schedule 1 Part 1 (Objectives, Principles and Definitions):

- (a) Amend part (i) of the definition of an Insolvency Event to remove the statement that excludes the application of the wording "it is proved to the satisfaction of the court that"; and
- (b) Remove part (vi) of the definition that defines an Insolvency Event to take effect where the value of the assets of the Contracting Wholesaler or the Contracting Retailer are less than its liabilities (taking into account contingent and prospective liabilities).

The proposed solution will therefore require a court confirmation as part of an application for a winding up order on the basis of a Contracting Trading Party fulfilling the "Cash flow test" or "Balance sheet test" and remove the commercial possibility of a default being triggered by a financial position short of a formal insolvency trigger.

³ 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

CPW115 was consulted on between 29 January 2021 and 19 February 2021. There were 14 respondents: seven Wholesalers, six Retailers, and CCW. We summarise the key themes from respondents below:

Respondent views on the impacts arising from the current definition of an Insolvency Event in the WRC

Six Retailers noted that the impacts of the current definition could be significant, while three Wholesalers noted that the effects would be negligible. The remaining respondents did not provide an explicit answer to this question.

Retailers noted customer impacts ranging from transfer and associated disruption, to the collapse of the retail market given the loss of one or more significant Retailers. In addition, Retailers noted that Retailers directed to be Interim Suppliers could also encounter short term liquidity and resourcing issues and that Wholesalers would be at risk for sums owed should the Retailer be declared insolvent and have its licence revoked. A Retailer stated that whilst it did not expect many Wholesalers to terminate a contract on the basis of negative net assets alone, such termination remained a possibility. It suggested that recent Covid-19 related measures may have affected the likelihood of this happening.

A Wholesaler stated that in its experience, default does not automatically lead to the termination of the Wholesale Contract and instead leads to discussion with Ofwat and MOSL to explore all other possible avenues with termination being the last resort. In addition, it noted that it was unable to think of a similar commercial contract where a court is required to pronounce judgment before a party is entitled to commence termination.

This Wholesaler also stated that the WRC provides an alternative action for insolvency, whereby instead of contract termination the Wholesaler's exposure is minimised by preventing the Retailer from further expansion in that Wholesaler's Area. It went on to suggest that it is unlikely that contract termination would occur unless bills were also going unpaid. It suggested that this provides a reasonable balance between affording Retailers an opportunity to remain in the market whilst they improve their liquidity and protecting Wholesalers from incurring bad debt.

Another Wholesaler stated that a Wholesaler does not have an easy way to establish that a Retailer's liabilities are greater than its assets unless there was already a debt

recovery litigation process ongoing, in which case the court's opinion would be sought anyway.

CCW stated that it was difficult to predict the impact, and questioned whether the existing arbitration provision in the WRC could provide a route for a Trading Party to contest the validity of a contract termination based on the existing definition of an Insolvency Event.

Two Wholesalers did not comment specifically on the impacts of the current definition and suggested the decision should sit with the regulator.

Views on the impact of the change to the definition of 'Insolvency Event' proposed by CPW115

Six respondents (one Wholesaler and five Retailers) stated that the change would have positive impacts and three respondents stated it would have negative impacts (two Wholesalers and CCW). Five respondents did not provide an explicit answer to this question.

The five Retailers that indicated the change would have positive impacts cited that aligning the WRC more closely to insolvency law and practice would prevent the crystallisation of significant negative outcomes to customers.

A Retailer added that the proposed amendments were in line with commercial contracts and stated that it was unclear as to why the WRC adopted a narrower definition than that included in the IA86. In contrast, a Wholesaler stated that in the usual course of commercial contracts, it is common for parties to be able to terminate a contract where in the view of one party to that contract, the other party is unable to pay its debts. It therefore argued that the proposed change seems to be suggesting that the retail industry's financial situation is unstable by comparison with others and that it should be given the additional protection of the courts before a default can be deemed an Insolvency Event under the Wholesale Contract.

Another Wholesaler stated it viewed a company whose liabilities exceeded their assets as insolvent, and suggested that the proposal would undermine a conscious decision by regulators to protect customers and preserve the balance of risk where the codes were intentionally designed to negate the requirement for court action and associated delays.

CCW stated that the proposed removal of the negative net assets criterion could be inappropriate given its recognition in the IA86, and noting its legitimacy as a measure of financial stability. CCW also stated that it was difficult to provide a definitive position in the absence of original rationale for the codified definition.

Views on whether CPW115 is proportionate, appropriate and better facilitates the codes principles

Nine respondents (six Retailers and three Wholesalers) agreed that CPW115 is proportionate to address the issue identified, is appropriate for the market and better facilitates the WRC's principles. Three Wholesalers disagreed and one neither agreed nor disagreed.

CCW stated that it is difficult to conclude that the Proposer's stated risks to the market are fully justified, and as such, cannot say whether the solution is proportionate or appropriate for the market.

Panel recommendation

The Panel considered this Change Proposal at its meeting on 4 March 2021. It recommended, by majority, that the Authority approve this proposal (seven votes for, two votes against, with four abstentions). This recommendation has been made on the basis of improving the principle(s) of Efficiency, Proportionality, Transparency, Simplicity, cost-effectiveness and security, Barriers to entry, Non-discrimination, and Customer-participation. The recommended date of implementation is 31 March 2021.

Panel members noted that that the solution would effectively enshrine the court's role in the code rather than allowing resolution within the market and one Panel Member expressed concerns around the proportionality of the solution when considered against the issue identified. In addition, it was stated by a Panel member that negative net assets could be an important indicator to a company incurring financial difficulties leading up to default.

It was also noted that Trading Parties had not acted yet where negative net assets had been reported. Other Panel Members noted that they felt the negative net assets test on its own caused uncertainty and risk to the stability of the market and the Proposer noted that the courts currently did not have a role and it was not possible to negotiate or discuss resolution. It was also noted by Panel that many well-known international corporations traded with negative net assets.

Our decision and reasons for 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 the proposal for the reasons given below.

Ofwat view on the implications of implementing the Change Proposal

The fact that Wholesalers can terminate Wholesale Contracts on the basis of a Retailer having negative net assets would still remain an option under the Change Proposal. However, the Change Proposal would delay a Retailer being classed as a Defaulting Trading Party until the Wholesaler confirmed the value of the assets of the Contracting Retailer are less than its liabilities or it is unable to pay its debts to the satisfaction of the court.

In relation to the risk that Wholesalers terminate Wholesale Contracts solely on the basis of a Retailer satisfying a negative net assets test, we note that - to date - no Wholesaler has sought to terminate a Wholesale Contract due to an Insolvency Event. Whilst this does not mean this could not happen in the future, arguably there is limited incentive for a Wholesaler to terminate a Wholesale Contract if a Retailer is otherwise viable and continuing to meet its payments. In any case, the Change Proposal does not prevent Wholesalers from terminating Wholesale Contracts on the basis of a Retailer having negative net assets.

In addition, the exclusion of the requirement to prove - to the satisfaction of the court - that a Retailer is unable to pay its debts or the value of its assets are less than its liabilities, does not negate the requirement on Wholesalers to be able to evidence that this is the case where they choose to commence Wholesale Contract termination on this basis under the WRC. In the case of the Retailer, it is only subsequent a correct Defaulting Trading Party classification under the WRC that a Wholesaler may choose to terminate the Wholesaler Contract, enforce rights under various credit support arrangements or remove the Retailer's right to submit Transfer Registration Applications or request New Supply Points in their Area. Protections are also afforded to Retailers from termination, or the use of other measures, where it has been incorrectly classified as a Defaulting Trading Party by reference to both section 11.2.4 of the Business Terms⁴ and the Water Industry Act 1991⁵.

In common with other commercial contracts, the definition of Insolvency Event in the WRC does not replicate insolvency legislation and instead is a common commercial contractual provision. If a company has negative net assets this can be material to suppliers when they consider whether to commence or continue to supply that

⁴ Section 11.2.4 Business Terms, WRC: If the Contracting Wholesaler takes steps to terminate the Wholesale Contract otherwise tha[n] in accordance with this Section 11.2, the Authority may take action, including enforcement action, in accordance with its statutory powers and policies or guidance as issued from time to time.

⁵ Section 66DA(4) and section 117F(4) of the Water Industry Act 1991 enable Ofwat to give a direction to a Wholesaler or Retailer to do, or not to do, a thing specified in the direction where it considers that the relevant party is not acting in accordance with the WRC.

company. It is designed to provide the contracting party protection against the risks of being obliged to continue to contract with a company which is either not paying its debts as they fall due, or which has negative net assets and is therefore balance-sheet insolvent.

Whilst we note the comments raised by the Proposer regarding interim supply, it does not immediately follow that the fact that a Retailer is classed as a Defaulting Trading Party whether by reference to an Insolvency Event or otherwise it will result in a Wholesale Contract being terminated, and a need for an interim supply event to occur. Section 11 of the Business Terms sets out the process that must be followed by a Wholesaler wishing to terminate its Wholesale Contract with a Retailer and includes the requirements that:

- a Retailer must be classed as, and remain classed as, a Defaulting Trading Party for a Wholesaler to terminate;
- the Wholesaler must provide Ofwat with at least 10 Business Days' notice of its intention to terminate the contract prior to the date of termination;
- relevant notices must be provided to Ofwat, MOSL and WICS; and
- Ofwat may take enforcement action where a Wholesaler seeks to terminate the Wholesale Contract other than in accordance with section 11.2 of the Business Terms.

Relevance therefore to whether the definition of Insolvency Event should be amended is limited.

Risks to customers of approving the Change Proposal

If the proposed change was implemented, risks to customers could arise if Retailers continued to acquire significant numbers of SPIDs while technically 'insolvent' (i.e. the Retailer had negative net assets) and subsequently failed. This has the potential to increase bad debt risks to Wholesalers (and subsequently customers) and lead to potential risks to customers who are acquired whilst the Retailer is insolvent. The current definition allows Wholesalers to manage this risk to an extent by limiting the Retailer's ability to acquire new SPIDs.

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