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# **Alternative credit arrangements in the Business Retail Market – a guidance document**

**Ofwat**

## About this document

Our [Review of Incumbent Support for Effective Markets](#) ('Project RISE'), published in August 2020, found that overall there was scope for incumbent companies (also referred to in this document as Wholesalers) to play a more active role in supporting the development of competitive markets. In particular, we identified that incumbent companies were, in our view wrongly, using competition law as reason not to collaborate or as reason not to be more responsive to the needs and specific circumstances of individual market participants. This covered a range of issues, including providing and declining proposals for alternative credit arrangements. In our view, this 'one size fits all' approach is not conducive to a dynamic and innovative market that can deliver benefits to customers and society, and as a result we committed to providing guidance targeted at those issues where we feel support to Wholesalers and Retailers is most needed. The availability and operation of alternative credit arrangements was one such area where we believed further guidance was appropriate.

This document therefore sets out our expectations of Wholesalers in their approach to offering alternative credit arrangements in the Business Retail Market. It sets out high level guiding principles and behaviours that we expect Wholesalers to act within when considering their approach to alternative credit arrangements. The guidance is also intended to help provide clarity around some of the issues that Wholesalers have cited as a barrier to offering alternative credit arrangements.

It is for Wholesalers to ensure that they are complying with their obligations under competition law, and to take their own legal advice, where necessary.

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# 1. Introduction

Competition and markets can deliver significant benefits for not only customers, society and the environment, but also for incumbent companies by bringing cost efficiencies, encouraging higher service levels and incentivising innovation. In doing this, they can help the sector meet its strategic challenges associated with climate change, population growth, affordability and changing customer expectations. Markets do this by allocating resources effectively and encouraging buyers and sellers to seek each other out and agree mutually beneficial trades.

In [our strategy](#), we set out our aim to continue focusing our attention on markets, where they can bring the biggest benefits to customers. Our [forward programme for 2021/22](#) includes an aim to improve the effectiveness of markets in delivering value for customers and promoting innovation to help achieve the sector's wider sustainability goals. Our ambition is to drive growth in the benefits the Business Retail Market brings for customers and the environment.

Given their privileged position in providing essential wholesale services, incumbent companies have a pivotal role to play in supporting the development of an effective and well-functioning Business Retail Market. Cumbersome and inefficient Wholesaler-Retailer interactions have consistently been identified as one of the three main market frictions undermining efficient market functioning and can increase operational and entry costs for Retailers (and subsequently customers), with credit and working capital costs being among the main costs facing Retailers when entering and operating in the Business Retail Market.

## 1.1 What are credit arrangements?

The opening of the Business Retail Market in April 2017 provided the opportunity for around 1.2 million eligible customers to choose their supplier of water and wastewater retail services. The separation of business retail activities and provision of these services by new entities (business Retailers) introduced a new counterparty risk to Wholesalers in the event that a Retailer defaults and exits the market.

Credit arrangements are an important aspect of any market arrangements and are a common feature of regulated markets. They are primarily intended to manage the financial risks of Retailer default, because if credit arrangements do not adequately address the risks that Wholesalers are exposed to in the market then they could potentially, in extreme circumstances, impact on the financial viability of the Wholesaler and the delivery of the essential water and wastewater services that customers rely on. Whilst Wholesalers do bear a portion of the costs should a Retailer default, some of these costs are also carried by customers as part of the price control reconciliation mechanisms.

It is therefore important that the credit arrangements in the market represent a fair and efficient allocation of risk, and effectively strike a balance between

- the need to ensure that Wholesalers (and subsequently customers) are not exposed to undue risk; and
- the need to ensure that the credit arrangements support competition in the market for the benefit of customers.

In seeking to meet this objective, we introduced [a suite of regulated credit terms](#) into Schedule 2 of the Business Terms of the Wholesale Retail Code ('WRC'), recognising the market power of Wholesalers in any negotiation over these terms and the incentive and/or opportunities that they may have to create barriers to entry into the market.

In an effectively competitive market where multiple buyers and sellers exist, we would expect some risk sharing to be agreed commercially between the two parties that reflect different levels of risk posed by different Retailers. We therefore included the flexibility for Wholesalers and Retailers to agree alternative credit arrangements between them. Schedule 3 of the WRC sets out the terms upon which Wholesalers and Retailers can enter into negotiations for alternative credit arrangements. In particular, it states:

*"Where a Contracting Retailer seeks to establish arrangements for Alternative Eligible Credit Support with the Contracting Wholesaler, the Contracting Wholesaler shall be obliged to give due and proper consideration to such proposals. Both parties shall be obliged, in relation to the proposals:*

- a) to act reasonably towards one another and without unreasonably delay, and*
- b) to negotiate in good faith with each other"*

Whilst there have been a number of alternative credit arrangements agreed between Wholesalers and Retailers<sup>1</sup>, the evidence suggests that these arrangements have tended to be blanket, 'one size fits all' arrangements, which may not reflect the differences in risk posed by different types of Retailers, with Wholesalers using competition law as reason not to collaborate or as reason not to be more responsive to the needs and specific circumstances of individual market participants.

This document is intended to clarify our position in respect to schedule 3 arrangements and to give guidance to Wholesalers and Retailers who may consider entering into these arrangements, where appropriate. It is Wholesalers' responsibility to ensure that they are complying with competition law requirements and to take their own legal advice, where necessary.

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<sup>1</sup> Details can be found on the MOSL website at <https://www.mosl.co.uk/credit-arrangements>

## 1.2 Why credit is important

The requirement to provide credit support is important to manage the financial risk to Wholesalers (and therefore customers) of Retailer default. However, it increases the costs of market entry and operation for Retailers and may inhibit the ability for Retailers to expand, innovate or improve their service offerings. It is therefore important that Retailers have access to appropriate credit facilities that reflect the risk profile of the Retailer in question.

We are concerned that some Wholesalers appear to have interpreted the WRC in an extremely narrow way that suggests, where they have agreed alternative credit arrangements with a specific Retailer that they must then also offer to other Retailers the same terms, regardless of the Retailers' specific characteristics (i.e. even if the Wholesaler considers them to carry a different risk profile) so as to ensure compliance with competition law. This is not correct, nor is it in line with the spirit in which the WRC was written. Further, in our view, this 'one size fits all' approach is not conducive to a dynamic and innovative market that can deliver benefits to customers and society and does not demonstrate Wholesalers supporting the development of the Business Retail Market – indeed, it could be viewed as being contradictory to this aim and could stifle potential innovation.

The rest of this document is structured as follows:

- Section 2 sets out the relevant key findings from project RISE;
- Section 3 provides detail on competition law considerations and relevant precedent;
- Section 4 sets out the Principles for Wholesalers to adopt in their approach to alternative credit arrangements ;
- Section 5 outlines why it is important that Wholesalers demonstrate the principles set out in section 4;
- Section 6 sets out our next steps and expectations.

## 2. Findings from Project RISE

In May 2019, [we wrote to the 15 English water companies](#) to make it clear that overall levels of support for markets at that time were unacceptable. The letter challenged companies to improve, and asked them to provide evidence to demonstrate where and how they were actively supporting markets. In August 2020, Ofwat published [the findings from its Review of Incumbent Support for Effective Markets \(Project RISE\)](#), following analysis of the written submissions and other information provided in response to our challenge. Overall, the review found that there was room for incumbent companies to play a more active role in supporting the development of markets, including the Business Retail Market.

In particular, one of the key findings was that:

**Collaboration can support markets and thereby benefit customers. A common theme was incumbent companies, in our view wrongly, using competition law as reason not to collaborate or as reason not to be more responsive of the needs and specific circumstances of individual market participants**

This finding was particularly relevant to the issue of alternative credit arrangements that can be agreed under Schedule 3 of the Business Terms of the WRC. The intent behind introducing the ability for Wholesalers and Retailers to negotiate alternative credit arrangements was to provide the flexibility for parties to agree commercial terms bilaterally, outside of the regulated arrangements within the WRC, as would normally be the case in a competitive environment. While there is some evidence of good practice in this area, for example Wholesalers offering a menu of alternative credit arrangements, there is limited evidence that Wholesalers have thoroughly considered and negotiated with Retailers, responded positively to Retailer-led proposals for alternative credit arrangements or proactively tailored their offerings to the circumstances of particular Retailers or sub-sets of Retailers.

Cumbersome and inefficient Wholesaler-Retailer interactions were identified as one of the three main market frictions undermining efficient market functioning in our first state of the market report. This market friction was also found to be prevalent in year two of the market's operation. Our assessment of year three is that industry efforts to improve market functioning have accelerated, aided by collaborative leadership from the market operator (MOSL). However, we find that resolution of market frictions continues to require urgent attention from all trading parties if the improvements we have seen to date are going to really gain traction and increase going forward. In this context, while we have seen some Wholesalers respond to our challenge in Project RISE, our concern is that not enough is being done on the issue of alternative credit arrangements to help improve the overall functioning of the market.

### 3. Competition Law considerations

It is Wholesalers' responsibility to ensure that they are complying with competition law requirements and to take their own legal advice, where necessary. The information contained within this section sets out Ofwat's position in response to Wholesalers citing the potential breach of competition law as rationale for not offering alternative credit agreements to Retailers.

#### Prohibition on the abuse of a dominant position

Chapter II of the Competition Act 1998 ('the Act') prohibits, in certain circumstances, conduct by one or more undertakings which amounts to an abuse of a dominant position. Section 18(1) of the Act says:

*'...any conduct on the part of one or more undertakings which amounts to the abuse of a dominant position in a market is prohibited if it may affect trade within the United Kingdom.'*

Section 18(2) of the Act then says:

*'Conduct may, in particular, constitute such an abuse if it consists in - ... (c ) applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage...'*

There is an equivalent prohibition set out in Article 82 of the Treaty on the Functioning of the European Union. Notwithstanding the UK's exit from the European Union, the existing European case law still applies within the UK and remains as sound legal precedent for the time being.

The prohibition is on the abuse of the dominant position - not on the holding of a dominant position in a market which includes treating dissimilar situations in the same manner. However, conduct may not be considered to be an abuse, even if competition may be restricted, if the conduct can be objectively justified and if the effect is that customers ultimately benefit. Whether specific conduct by a dominant market player can be objectively justified is a question of fact to be considered on a case by case basis.

In *RWE Generation UK Plc v Gas and Electric Markets Authority*<sup>2</sup>, RWE, a generator of electricity, brought a judicial review claim in relation to an element of Ofgem's charging scheme. In particular, the case discussed the principle of non-discrimination. The High Court said that the principle does not preclude consideration of whether there is a material difference between the situations of one group of economic operators as compared to

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<sup>2</sup> [2015] EWHC 2164 (Admin)

another group in order to see whether or not particular differential treatment is intended to be prohibited.

At paragraph 41, the Judge said

*‘...The general principle requires that comparable situations are not to be treated differently, or different situations treated in the same way, without objective justification. On occasions, the focus is on a two-stage process: are two situations comparable and if so, is any differential treatment objectively justifiable? On other occasions, the two questions tend to be merged into a single issue, that is, is there a relevant difference between the two situations sufficient to justify the differential treatment?’*

Then at paragraph 45:

*‘...the decision in relation to the Peak Security Tariff does not involve unlawful discrimination between classes of users in a way precluded by the Directive or, indeed, any general principle of EU law prohibiting discrimination. Any differential treatment is based on a material, relevant difference arising out of the system relating to the making of investment decisions.’*

In other words, the High Court said that Ofgem was permitted to differentiate between different classes of users on the basis of the different impact that those users have on the costs incurred by the electricity transmission owners. Ofgem’s argument, which the High Court agreed with, was that such differentiation is compatible with the principle of non-discrimination, and can contribute to a cost-effective system and promote effective competition.

## **The water retail market and the abuse of a dominant position**

The WRC also contains principles in relation to non-discrimination and barriers to entry:

- The principle of non-discrimination is set out in Schedule 1, Part 1 to the WRC, at Part A, paragraph 1.5.6, as follows:
  - *The Wholesale-Retail Code and arrangements established by or under the Wholesale contract should not unduly discriminate, or create undue discrimination, between the contracting Retailer and other Retailers or Applicants’.* This makes clear that the prohibition on discrimination is not a requirement to impose a “one size fits all” approach, but to consider whether there may be objective reasons for applying different approaches to different Retailers, depending on their characteristics.
  - The principle of no barriers to entry is set out in Schedule 1, Part 1 to the WRC at Part A, paragraph 1.5.5, as follows:

- *The Wholesale-Retail Code and arrangements established by or under the Wholesale Contract should not create barriers to entry in respect of the Competitive Market and should promote effective competition in the Competitive Market.'*

Wholesalers are required to extend credit to Retailers in order to facilitate their participation in the market. As a Retailer cannot serve its customers without being granted access by the relevant Wholesaler to the network to which those customers are attached, that Wholesaler is likely to be in a dominant position in relation to the relevant Retailer and as such, is subject to the general prohibition on abuse of a dominant position under UK competition law, as well as the requirements of the WRC.

We noted in Project RISE that *'...several companies have declined to give Retailers credit offerings to reflect their specific characteristics, instead maintaining a one-size-fits-all approach.'* We then said *'While Wholesalers should not discriminate between Retailers, there is nothing preventing Wholesalers agreeing alternative credit arrangements that are specific to the Retailer in question, providing that any difference can be objectively justified.'*

It remains Ofwat's position that the provision of tailored credit arrangements to Retailers, either by way of a menu of credit arrangements or through a bespoke agreement, if objectively justified and reflective of the risk profile of the Retailers, would not of itself constitute any breach of the competition law prohibitions or of the non-discrimination principle within the WRC. This is not the same as applying dissimilar conditions to equivalent transactions or unfairly discriminating between Retailers. Rather, it is based on a legitimate calculation of the level of risk that each Retailer poses to the Wholesaler at the time when the credit is offered. This objective justification for offering different credit arrangements to different Retailers means, in Ofwat's view, that there is unlikely to be an abuse of a dominant position here, and that customers should ultimately benefit.

This could potentially reduce, to some extent, the cost burden on Retailers and allow them more scope to expand, operate more efficiently, and promote innovation. These factors can all in turn contribute to reducing barriers to the development of competition within the market.

As set out in the European Court examples above, offering one type of credit to Retailers does not in and of itself insulate a Wholesaler from a breach of the Competition Act 1998. Wholesalers should be responsive to Retailers' needs as appropriate and by simply only offering one type of agreement, this could impede competition where different Retailers require and justify differing credit arrangements. We see this type of behaviour as not supportive of markets and it is what this guidance aims to help resolve.

## 4. Principles for Wholesalers

As set out in our findings from Project RISE, we expect Wholesalers to play a more active role in supporting the development of effective markets. This includes acting in a way that goes beyond simply complying with market rules, and instead acting in a way that is consistent with the spirit in which the rules were written and in the interests of the market and customers.

In this context, Wholesalers should not discriminate between Retailers when considering alternative credit arrangements, but this does not mean that Wholesalers are prohibited from agreeing bespoke alternative credit arrangements that are specific to the Retailer(s) in question, or providing a menu of alternative credit arrangements if they choose to do so, providing that any difference can be objectively justified. And the European Court of Justice made clear that failing to provide terms tailored to the specific characteristics of customers (e.g. Retailers) may also be an abuse of a dominant position contrary to competition law where it prevents those customers from competing with each other on a level playing field.

Wholesalers and Retailers are able to negotiate bespoke arrangements which reflect objectively justifiable differences between Retailers, including the risk profile of the Retailer in question which in turn may be influenced by other factors, including for example the business model or ownership structure of the Retailer. These need not be offered unconditionally to all Retailers (although a Wholesaler could choose to do that if it wished) but they must be offered to other Retailers who exhibit similar characteristics to those which justified the difference in treatment. Similarly, if a Wholesaler chooses to offer a menu of alternative credit arrangements, it would need to ensure that where Retailers were offered terms within the menu, that this approach can be objectively justified. Risk assessments need to be objective, transparent and consistently applied.

There are many factors to consider when assessing the credit risk of individual Retailers. Areas to consider in respect of the Retailer could include, but are not limited to:

- Financial resilience, taking into consideration such matters as capital / ownership structure and the availability of additional finance to the business;
- Risk mitigation benefits to the Wholesaler through the diversification of its customer base;
- Payment record with a regular and timely payment profile being an indication of the suitability for increased credit facilities;
- Market rating and business model;
- Available security; and
- Terms and conditions on which the additional credit facility is to be made available.

The criteria used when assessing credit risk should be consistently applied across all applications from Retailers without there being any actual or perceived bias.

When assessing credit risk, Wholesalers may also look to utilise the services of credit reference agencies. Their scoring protocols and suggested credit limits may form the basis of an objective methodology for the assessment and granting of credit facilities. Wholesalers should be open to alternative structures which reflect the dynamic nature of the Business Retail Market and those operating within it.

Appropriate feedback should be given on all credit applications so that Retailers understand how and why Wholesalers have arrived at decisions on alternative credit arrangement proposals from Retailers.

We are aware of examples where a small number of Wholesalers have refused alternative credit arrangements on the basis that, if agreed and offered to other Retailers, the cumulative risk exposure to the Wholesaler would be deemed too high. While it is a commercial decision for Wholesalers to take, each Retailer is likely to carry a different level of risk. We therefore do not expect Wholesalers to take an approach whereby they refuse to negotiate or agree alternative credit agreements because they deem their cumulative risk exposure, across the Retailers operating in its area, to be too high. Such an approach is not consistent with the principles included within this guidance and is in contrast to assessing each Retailer's individual credit risk objectively.

The European Court of Justice has stated that in some circumstances it may be discriminatory to treat those with different relevant characteristics in an identical way. In Case 13/63, Italian Republic v Commission of the European Economic Community [1963], ECR 165, the Court said

*'The different treatment of non-comparable situations does not lead automatically to the conclusion that there is discrimination. An appearance of discrimination in form may therefore correspond in fact to an absence of discrimination in substance. Discrimination in substance would consist in treating either similar situations differently or different situations identically.'*

Competition law therefore, as well as the WRC, requires Wholesalers to engage constructively with Retailers and properly consider their requests for bespoke credit arrangements. When offering or considering alternative credit arrangements, we expect Wholesalers to comply with the following principles:

## **1. Supporting market development**

- to act within the boundaries of competition law and the provisions of the WRC; including by ensuring that credit agreements reflect objectively justifiable differences in the risk posed by different retailers – Wholesalers may choose to do this by negotiating and agreeing bespoke credit arrangements or by offering a menu of alternative credit arrangements.
- to act within the letter and spirit of the market rules to develop and thoroughly consider proposals that could ultimately be for the benefit of the market and customers, taking into account this guidance and in line with the requirements of the WRC, including the non-discrimination principle of the WRC.

## **2. Collaboration**

- to actively consult with Retailers in proactively developing alternative credit arrangements and to keep the approach under regular review;
- to fully engage and work collaboratively with Retailers, giving full consideration to and entering into constructive negotiations on their proposals for alternative credit arrangements.

## **3. Transparency**

- to act transparently in both negotiating and communicating what is available to Retailers by publishing information requirements and objectively justifiable assessment criteria.

## 5. Why it is important that Wholesalers demonstrate the principles

It is important that we see Wholesalers act in line with the legal provisions set out in section 3 of this guidance and adopt the principles set out in section 4. Our thinking on why this is important for the effective operation of the Business Retail Market is set out below.

### 5.1 Credit facilities in the Market

Credit facilities are a basic requirement for the functioning of many markets and an important source of short term working capital for businesses – in this case the Retailers in the business retail market. The availability of credit facilities can also make business operations more efficient as they facilitate payment flows and remove the requirement for payment in advance and numerous small payments to manage credit risks.

The current market arrangements may require Retailers to deploy significant amounts of working capital which are held by Wholesalers as security in the event of Retailer default. This effectively increases the capital requirements of individual retail businesses and leads to capital being tied-up and unused as it is supporting payment obligations rather than business development. Retailers and Wholesalers should consider the use of eligible third party instruments which guarantee payment of Retailer obligations in the event of default in order to reduce credit exposure.

If credit arrangements were more closely linked to individual Retailer performance and security, then the necessary requirements to access credit could be reduced and become more proportionate to the risk posed by that Retailer. The sector as a whole could then utilise the capital released to support business development and innovation, rather than this capital being tied-up unnecessarily as security for trading obligations.

The adoption of a range of alternative credit arrangements should strengthen the relationship and operations between Wholesalers and Retailers as there will be an increased flow of information and a better understanding of the Retailer's market position and risk profile. As Wholesalers develop a better understanding of Retailers and their specific business models, there should be a further development of the financial facilities being made available.

Wholesalers may also benefit from granting additional and different credit arrangements to Retailers as the risk arising from the individual Retailers may be diversified.

## 6. Next steps and our expectations

As set out in Project RISE and as stated above, while we have seen some companies review their approach to offering alternative credit arrangements in previous months, we expect to see a marked and sustained shift in Wholesaler behaviour when offering alternative credit arrangements to Retailers. Rachel Fletcher set out Ofwat's [vision for the Business Retail Market](#) at the MOSL CEO forum in November 2020, in which she acknowledged that the market is no longer new and is beginning to mature, and as such we want to see increased momentum and behaviour change to help relieve market frictions so that the market can deliver value for customers and society.

The existing Business Terms of the WRC include provisions which encourage Wholesalers to offer (and consider proposals for) alternative credit arrangements to Retailers where appropriate.

We know that where Wholesalers have offered alternative credit arrangements, these are mostly undifferentiated credit arrangements which are available to all Retailers. Such an offer does not recognise the underlying differences between retail businesses, their business models or ownership structures and Wholesalers are encouraged to make better use of these provisions to offer more tailored credit facilities to Retailers, where appropriate.

To avoid distortion of the market, credit facilities should be made available to Retailers in an open and transparent manner. Both the amount of credit and the payment terms should be offered to Retailers on a consistent basis, subject to a fair and objective assessment of their individual credit risk.

Wholesalers should consider (if not already in place) a dedicated area of their website that clearly sets out the range of alternative credit options available to Retailers. This should include publishing their information requirements and assessment criteria for alternative credit facilities so that Retailers can make full and complete requests for such facilities, subject to commercial confidentiality considerations.

We understand that fair access to credit for both new and existing Retailers is an important factor to an effective functioning market. It is a priority for Ofwat to see improvements in this area and we expect that by providing clarity on our position here we will better facilitate Wholesalers to act in accordance with the principles in this guidance and the spirit within which the market rules have been developed.

We will continue to actively monitor progress in this area closely and will consider contacting Wholesalers in due course to understand further the progress they have made in meeting our expectations.

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