Wholesale Retail Code Change Proposal – Ref CPW117

Modification proposal	Wholesale Retail Code Change Proposal - CPW117 - Shortening the late payment default timeline for a credit support reduction
Decision	The Authority has decided to approve this Change Proposal with modifications
Publication date	15 October 2021
Implementation date	5 November 2021

Background

For the payment of Primary Charges[1], Retailers can opt for either: Pre-Payment; Post-Payment; or Alternative Payment Terms with Wholesalers. Where Retailers opt for Post-Payment, they are required to provide Credit Support to the Wholesaler(s) with whom they enter into a contract, with the amount of credit required equal to 50 days of supply.

Where Retailers pay in arears ('post-payment') Wholesalers are exposed to the risk of bad debt associated with such Retailers defaulting and exiting the market. The credit arrangements introduced at market opening were designed with the intention that Wholesalers be exposed to ~40% of the total risk associated with Retailers exiting, with credit support covering the remaining ~60% (referred to as the 60:40 risk exposure split). Wholesalers are protected to some extent from the risk they bear by mechanisms in the current price control, which means the risks to Wholesalers are shared with customers[2].

The Wholesale Retail Code (WRC) Schedule 1 Part 2: Business Terms (Section 9.11) sets out the Credit Support Requirement for Retailers who select Post-Payment of Primary Charges, which is calculated on a monthly basis and is equal to the Credit Support requirement for the following Invoice Period less the Unsecured Credit Allowance

[1] Unless otherwise specified, the terms used in this document are those defined in the Wholesale Retail Code and/or Market Arrangements Code, including those approved by this Change Proposal.
[2] More information on the relevant mechanisms in the current price control can be found in the Authority's consultation on Proposals to deal with un-invoiced Wholesaler charges in the event of an unplanned Retailer exit, available here.

applicable to the Contracting Retailer (if any); and accrued interest (if any) from any cash deposited by the Contracting Retailer in the Cash Security Account).

The issue

The Change Proposal was developed and submitted by Everflow Water ('the Proposer)'. The issue raised in the Final Report is that the current working capital requirements for Retailers who opt for Post-Payment are seen by some of those Retailers as unnecessarily burdensome. The Proposer states that these arrangements require Retailers to maintain arrangements which carry high financing costs, and which ties up capital which they may otherwise be able to utilise in offering additional services to their customers.

The Final Report set out that currently the Proposer views:

- working capital requirements for Post-Payment Retailers as high and an unnecessary burden;
- the current credit requirements force Retailers into maintaining high financing costs, which is detrimental to their customers, whilst also inhibiting their ability to provide additional service offerings;
- the difficulties experienced through current credit support levels has been exacerbated by the Covid-19 pandemic, where Retailers have also been expected to offer financial support to their customers.

The Final Report also states that if this change is not implemented, Retailers will continue to be required to lodge credit at levels higher than necessary. The Proposer states that the change should improve Retailers' cashflow, improve market resilience and improve outcomes for customers.

The Change Proposal[3]

The proposed solution reduces the number of days within the late payment default and termination process within the WRC by 10 Business Days, in exchange for the same number of days being released from the Credit Support Amount due.

The mechanism to support this is a new payment option, additional to the existing Pre-Payment, Post-Payment and Alternative Payment Terms options, that Retailers can opt into. This new option, termed ‘Reduced Notice Post-Payment’ (RNPP), will involve a

[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

Reduced Default Notice Period Allowance that will apply to the Credit Support Notice that a Wholesaler issues. In exchange, there will be no delay between the payment due date and the date on which the Wholesaler sends out the late payment notice.

Currently, section 10.1.1 of the Business Terms sets out the circumstances in which a Retailer will be classed as a Defaulting Trading Party where they have not paid on time. Where the Contracting Retailer has failed to pay an amount properly due of more than £5,000 (exclusive of VAT):

a. 10 Business Days after the payment due date, and then
b. on or after the last Business Day set out at a. above, five Business Days' following the issue of a notice by the Contracting Wholesaler to pay the outstanding amount

In the industry consultation, three potential solutions were put forward to address the issue.

These options were:

1) Consistent approach across the market – all Trading Parties would be required to follow the amended timeframe (where the timeframe in which a Retailer will be classed as a Defaulting Trading Party is reduced by 10 Business Days) in respect of section 10.1.1 of the Business Terms (referred to as the 'default timeline' for the purposes of this document) to reduce credit support amounts.
2) Retailers are able to opt into the Reduce Notice Post Payment arrangement (RNPP) – creation of a new option to reduce the default timeline for those Retailers that want to offset the credit support amount.
3) Bespoke Trading Party agreements – individual changes to the default timeline would be agreed between the relevant Trading Parties.

Following industry consultation, two approaches were discarded. Option 1 was discarded as it removes choice, especially for those Retailers who may prefer to retain the current timeline set out at section 10.1.1 of the Business Terms. Option 3 was discarded mainly due to the complexity it would introduce from an administrative and systems change perspective for Trading Parties. The Final Recommendation Report sets out that the solution taken forward is option 2.

Additionally:

- Retailers will be able to opt into or out of the RNPP option once in a 12-month rolling period.

- Retailers will be required to notify their Contracting Wholesaler(s) at least 20 Business Days in advance of the P1 Settlement Report for the Invoice Period that they are opting into the RNPP.
- Reconciliation of Primary Charges with respect to Settlement Runs will be the same as the Post-Payment option.
- Once the Retailer opts into RNPP, the default timeline would apply from the next Invoice Period following that opt in being processed correctly.

Industry consultation and assessment

The Change Proposal was developed by the Proposer initially informally with a broad range of market participants (including CCW) and subsequently consulted on. The consultation for CPW117 ran between 20 April 2021 and 12 May 2021 and received a total of 20 responses (ten Wholesalers, nine Retailers and CCW). A summary of responses is set out below.

Q1. Which is your preferred option? What are the benefits of your preferred option over the other two?

Option 1 was favoured by four Wholesalers and four Retailers – the primary reasons set out in the consultation responses for this option was that it was seen to offer the maximum benefit for the market whilst reducing complexity for Trading Parties. It was also stated that this option would give the market consistency and be the easiest to implement.

Option 2 was favoured by two Wholesalers, four Retailers and CCW – the reasons set out for support of this option included that it represents an increased level of flexibility for Retailers and would reduce barriers to entry to the market. Suggestions to limit the frequency of switching to RNPP were documented in the responses and subsequently included in the solution discussed by the Panel and included in the Final Recommendation Report. Those who did not support this option stated that it may increase the chances of Retailers exiting the market, as it limits the time available for Retailers to remedy financial issues that causes the late payment or failure to provide requisite credit support.

Option 3 was supported by one Wholesaler – whilst the respondent did state this option as their preferred, they did state that many Retailers choose to form Alternative Eligible Credit Support (AECS) agreement and it questioned the need for further changes to the WRC.

Three Wholesalers and one Retailer stated that they did not favour any of the options – the reasons outlined in the consultation responses included that it could put increased pressure on Retailers to correct temporary issues with payment procedures, could cause multiple Retailer failure and may cause lending costs in the market to increase. Some respondents did not view the changes as cost neutral due to the potential costs that could be incurred by Wholesalers should Retailers be entering into persistent debt and preferred bespoke agreements. It was also stated by one respondent that alternative payment terms may not have been found to be unsuccessful at this point and therefore the proposed solution may not be necessary.

Q2. Are five (5) Business Days (BDs) enough time for Retailers to correct any late Primary Charge payment? Please explain your answer.

Six Wholesalers and eight Retailers agreed that five (5) Business Days is enough time to correct any late payment. The responses in agreement stated late payments are usually likely to be in error which can be rectified through quick banking processes. There was a view that the period between the publication of Primary Charges and their payment due date does provide sufficient time needed to investigate issues and process payments. It was also stated that a shorter late payment default period would likely increase the reliability of payments and the response time to action past overdue payments. In addition, it was considered that most parties which have AECS arrangements in place likely already operate under shortened late payment windows.

Those who disagreed cited reasons such as Retailers are likely to require more than five (5) Business Days to correct late payment, citing self-suppliers specifically. Some respondents were concerned that a reduced late payment period would exert pressure on Retailers and could erode Wholesaler-Retailer relationships. It was also stated that internal processes and increased market complexity in payments arrangements can cause management of late payments within five (5) Business Days to be difficult. It was also stated that the Panel established Credit Committee[4] had considered reducing the late payment default period but had ultimately decided against it.

Q3 Considering administrative burden if option 2 is progressed, how often should Retailers be allowed to switch between five (5) BDs and fifteen (15) BDs for the late payment default process?

Two respondents suggested the frequency of the opt in process should be available once per month, 10 respondents suggested that the opt in process should be restricted to once per year to reduce the administrative burden to Trading Parties. Two respondents suggested it should be restricted to once per year or with bilateral agreement with 6 others providing no answer to this question.

[4] The credit committee is no longer in place at the time of this decision document

Q4 What is your experience of the current credit arrangements?

There were a broad range of experiences recorded in the consultation responses. Some provided examples of where resourcing costs are incurred to accommodate the evolving credit arrangements and stated concerns about increased burdens on administrative processes when offering more credit arrangements.

One response stated that the underlying principles of risk sharing have eroded since market opening and believes that the market code principles may not be an effective basis for decisions on reducing collateral requirements. It questioned whether reduced Retailer costs will directly generate customer benefits or that the Panel or Ofwat would be able to determine any such link. It was also stated that Retailers have full risk exposure to bad debt should customers fail, with little margin to absorb the exposure.

One response stated that current credit arrangements in the WRC are unfair and discriminatory, especially to independent Retailers. It was stated that credit support is the most difficult part of operating in the market and that current arrangements can be barriers for new entrants, whilst preventing small companies from growing. It was welcomed that several Wholesalers are now offering AECS but previously expressed concern on the scale of differences between benefits offered to privately owned businesses and those to publicly owned Retailers. One response stated that current credit arrangements are burdensome and constrain the opportunity to make efficiencies that can be passed onto customers. It also noted its favour for any proposal that makes credit arrangements more accessible for smaller Retailers in the market.

Q5 Please provide worked examples of the effect of credit requirements and the cost of providing these.

There were limited responses to this question. One Wholesaler detailed examples of AECS arrangements along with uptake levels. Retailers did not give any specific examples of the effects of current credit requirements responding mainly with costs of collateral requirements.

Q6 What are the benefits of this change to your company, and do they outweigh the cost of implementation and operation?

Wholesalers generally stated that they saw the benefits to the change being for Retailers. There were varying views as to how the change would affect risk exposure for Trading Parties. One Wholesaler stated their concerns about damaging Trading Party relationships and increased administrative effort.

Retailers cited that the benefits of CPW117 would outweigh any associated administrative burden. One Retailer stated that CPW117 would reduce costs, enable it to offer more competitive prices and provide additional services to customers. Option 3 was seen as the option with the most associated administrative burden. One Retailer did state that it would not utilise either options 2 or 3, if they were progressed, and option 1 would introduce uncertainty into its business that would increase the cost of lending. It stated that this would outweigh any reduction in the absolute level of working capital requirements. CCW stated that should option 2 be implemented it is important that Retailers use the released funds to the benefits of customers.

Q7. Are there any risks associated to the implementation of this change, such as the percentage reallocation of risk exposure between Wholesalers and Retailers?

Wholesalers had varying views as to whether the 60:40 split of risk exposure between Retailers and Wholesalers would be affected.

Three Wholesalers noted that the balance of risk would be changed from the current 60:40 allocation, one suggested there should be further exploration of the risk balance.

In one of the consultation responses a Wholesaler stated that the Change Proposal reduced the allocation of risk to Retailers by around 7% and suggested that to maintain the risk allocation at 60:40, the corresponding reduction in credit should be set at 9 days (rather than 14[5] as proposed).

Two Wholesalers commented that the effect on risk allocation would be neutral. One suggested that due to the number of eligible SPIDs there would be little impact. One suggested where there is a late payment the risk is neutral but where there is a sudden Retailer exit the risk exposure is changed to the detriment of the Wholesaler. One Wholesaler stated market stability/financial assurance risk, can be mitigated though if correct governance is applied. One Wholesaler suggested that with all options there is increased exposure to Retailer default risk.

Retailers viewed the change as broadly risk neutral and did not foresee any risks to the changes proposed in CPW117.

Q8. What are the impacts of this change on your systems and processes?

Wholesalers generally cited increased complexity from options 1 and 3, however three Wholesalers did state that that option 2 would attract the most complex changes. One

[5] 10 Business Days is assumed to be equivalent to 14 calendar days.

Wholesaler stated that the impact should be minimal if Retailers declare their choice on whether they are opting-in in advance every Month.

Retailers generally stated that there would be low levels of impacts to their systems and processes.

Q9 What are the cost and time implications of this change for your company?

Wholesalers and Retailers responded to this question in a manner similar to question 8. Most Trading Parties stated that option 1 would incur the fewest costs, with option 3 having the highest cost and time implications. One Wholesaler stated that option 2 would have the largest associated impact, due to the potential for Retailers to frequently change between five and 15 Business Days in the late payment default timeline. One response did state that option 2 would likely cause an increased number of formal notices sent by Wholesalers each month due to late payment behaviours.

Q10. Where Retailers have defaulted or exited the market in the past, would this [6]change have protected customers better?

Respondents found it difficult to respond to this question, as they were not aware of the exiting Retailers' customer profiles, nor privy to their financial situations.

Q11. Please explain the impacts of this change on your customers and whether it will benefit them, providing evidence of this.

Wholesalers generally pointed out that Retailers should benefit from the change, although some would likely benefit more than others. Some responses questioned whether reduced Retailer costs would be passed on to customers. One response stated that CPW117 should reduce customer costs if Retailer savings were reflected in retail tariffs.

Q12. Will the proposed change better facilitate the Objectives and Principles of the WRC? Please explain your answer.

Six Wholesalers, seven Retailers and CCW agreed that the change would better facilitate the objectives and principles of the WRC. Three Wholesalers and two Retailers disagreed, while one respondent had mixed views.

Those who agreed stated that the change would improve customer outcomes, increase operational efficiency, improve market competition and reduce barriers to entry. One response also stated that the change would increase liquidity in the market and remove existing market distortions.

One Retailer noted that the change only benefits Post-Payment Retailers, which places Pre-Payment Retailers at a disadvantage. It wishes this change to be made only if a comparable reduction in the late payment default timeline for Pre-Payment Retailers and the corresponding payment is also implemented. One response contended that this change would result in a higher number of Retailers defaulting, thereby causing end customers to suffer.

The respondent who had mixed views stated that the change delivers against the barriers to entry principle but is not proportionate as the risk reduction is not shared between Wholesalers and Retailers.

Q13 Do you agree with the proposed implementation date of 5 November 2021? Please explain your answer, including a view on whether CPW117 should be implemented sooner, if possible.

Eight respondents agreed with the implementation date of 5 November 2021. Three also agreed but requested implementation was no sooner. Three other respondents agreed and favoured an earlier implementation date if possible. Three respondents disagreed and three gave no indication as to their view.

Q14. Do you have any other comments?

There were a number of other comments set out in responses, including:

- One Retailer was pleased to see this innovative approach to credit requirements and is supportive of well-considered projects on this area of the market codes.
- One Wholesaler stated it is supportive of the change and its only major concern is ensuring compatibility/alignment with currently existing Alternative Payment Terms and AECS arrangements.
- A Wholesaler response suggested that MOSL considers the implications that CPW117 would have on CPW080, as well as considering Ofwat's recently published guidance on AECS.
- One Retailer responded that it believes this change will reduce costs in the market and should enable Retailers to better support their customers through improved services.
- A Retailer also noted that several credit changes have been raised since market opening and suggests a holistic review of credit arrangements would now be appropriate.

Panel recommendation

The Panel discussed the draft recommendation report at its meeting on 21 June 2021. The Panel recommended, by unanimous decision, that the Authority approve this Change Proposal. This recommendation was made on the basis of improving efficiency, customer participation and cost effectiveness[7]. The Panel recommended an implementation date of 5 November 2021.

Panel discussed at length the rationale for the Change Proposal and Trading Parties' views detailed in the draft recommendation report. Key discussion points included:

Customer impact

The Panel concluded that the Change Proposal would not negatively impact customers. It seeks to offer Retailers an additional payment option through which they can choose to reduce collateral requirements in exchange for a reduced default and termination period. The Panel considered that this should lead to increased Retailer offerings and better customer outcomes.

The Panel also discussed how increased cashflow due to opting for RNPP might be used by Retailers. It noted that it was for individual Retailers to decide whether to offer improved benefits to customers but hoped that competition in the market would encourage them to do so.

Market stability and balance of risk

The Panel noted that opting for a RNPP would reduce the default timescale by 10 Business Days which could accelerate a failing Retailer's exit from the market. A Panel Member noted that if a Retailer opts for RNPP and then subsequently exits the market Wholesalers would hold less collateral against amounts due than if they had opted for standard Post-Payment terms. The Panel discussed where the levels of default exposure lie but stated that they did not consider that the Change Proposal increases Wholesaler exposure in absolute terms since the amounts due would also be reduced.

Non-discrimination

The Panel discussed whether the change treated Retailers unequally thereby creating an imbalance in the market. Some Panel members expressed the view that the Change

[7] Note that the Panel's recommendation was made prior to implementation of CPW040/CPW121 on 1 September 2021 which introduced revised principles of the Market Arrangements Code and Wholesale Retail Code.

Proposal merely created an intermediate option between existing Pre-Payment and Post-Payment arrangements, and therefore it seems unlikely that the impact of changes for this option would be outside those existing arrangements.

Take up of proposed solution

The Panel discussed the potential level of take up of the proposed solution from Retailers and whether it was more of an attractive option than those currently available. The Proposer considered that it could be more accessible to Retailers than the current Post-Payment option, but ultimately it was for Retailers to assess any risks the RNPP might present to them and decide if they wish to opt into it.

Impact on currently agreed Alternative Credit arrangements

The Panel noted that, should the Change Proposal be approved by Ofwat, Retailers that currently hold Alternative Payment Terms or Alternative Eligible Credit Support agreements with Wholesalers may wish to review or revise their existing commercial arrangements.

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 approve the Change Proposal with the following modifications. The first modification reduces the credit requirement reduction to nine days for the reasons set out below. The second modification clarifies the drafting in the Business Terms, confirming that a Retailer may only amend its selection (whether opting-in or opting-out) once in a rolling 12 Month period.

Schedule 1, Part 1: Objectives, Principles and Definitions	"**Reduced Default Notice Period Allowance**" is the amount, expressed in pounds sterling, calculated on a monthly basis in accordance with the following formula $x=(\gamma/z)\times\cancel{14}9$ where: x is the Reduced Default Notice Period Allowance; γ is the amount specified in the P1 Aggregated Settlement Report and issued to the relevant Contracting Wholesaler and Contracting Retailer; and z is the number of days in the Month for which the Provisional Monthly Charge relates;
Schedule 1, Part 2:	The Contracting Retailer shall be permitted to amend its selection from Post-Payment to Reduced Notice Post-Payment ~~and~~ or from

Business Terms, section 9.2.1	Reduced Notice Post-Payment to Post-Payment in accordance with the terms of this Section 9 only once in any period of 12 Months, provided always that only one selection can be made for any given Invoice Period to which the Primary Charge relates.

We have concluded that the implementation of the modified Change Proposal will better facilitate the current Principles and Objectives of the WRC and is consistent with our statutory duties.

Customer Impacts

The **primary principle** confirms that the WRC and arrangements established by or under the Wholesale Contract shall be maintained, operated and developed in a manner that best seeks to protect and promote the interests of, and participation by, existing and future Non-Household Customers. We agree with the position set out in the Final Report and the view CCW put forward at the Panel meeting. By implementing a modified version of the Change Proposal, Retailers may make use of funds which would otherwise have been lodged as credit support to provide better offerings to customers and thereby help to promote competition in the retail market which is in customers interests. We strongly encourage Retailers that opt into RNPP to demonstrate that they are able to innovate and deliver better outcomes for customers with the benefits associated with this change in credit support requirements.

Market stability and balance of risk

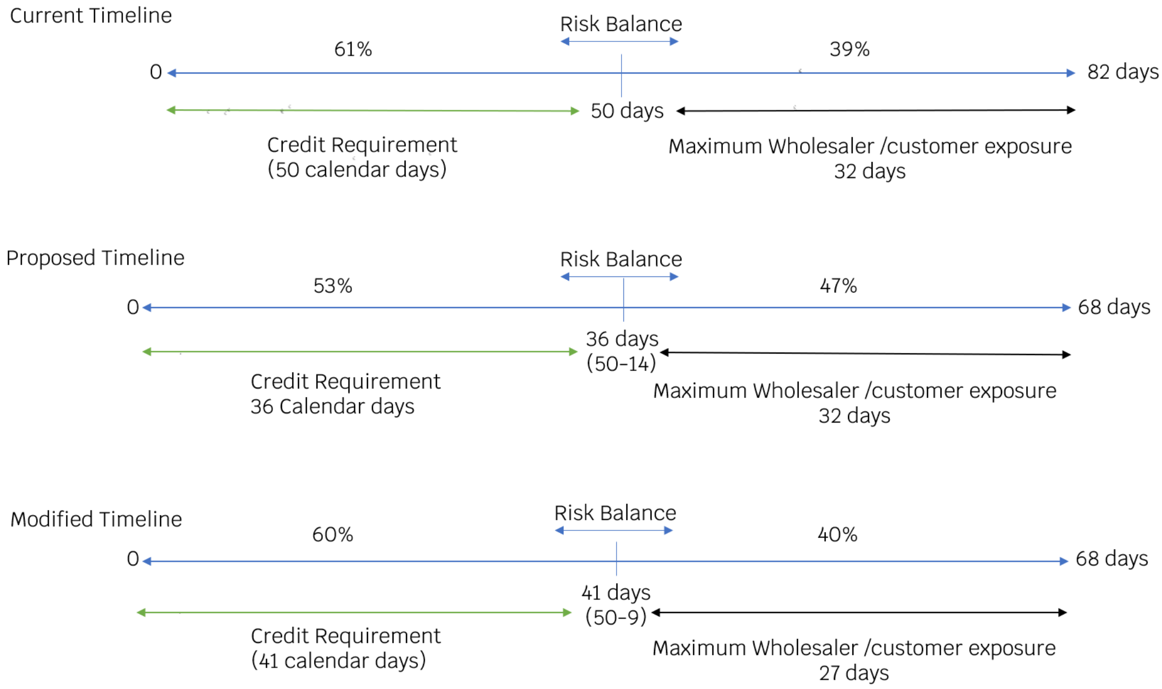
It is our view that the underlying principle of the Change Proposal has been well considered and it is reasonable to give Retailers the option to choose to reduce the timeframe in which they can become a Defaulting Trading Party in return for a reduction in collateral requirements. The proposed change builds on long standing processes within the WRC that Trading Parties are familiar with, rather than seeking to redesign them. We consider therefore that the Change Proposal furthers the **supporting principle of simple, cost effective and secure**.

We note the Panel's assertion that by opting for a RNPP it would reduce the default timescale by 10 Business Days which could in turn accelerate a failing Retailer's exit from the market. If a Retailer is going to fail and exit the market, then accelerating such exit could be in customers' interests. But a Retailer having to exit the market just because it did not have sufficient time to resolve an issue must be avoided. Evidence to date suggests that it is rare that late payments (i.e. those requiring notification under section 9.10.1 of the Business Terms indicating that payment is 2+ Business Days late) escalate with relatively few instances of a Retailer subsequently being classed as a Defaulting Trading Party. In addition, it does not follow that the classification of a Retailer as a Defaulting Trading Party will automatically mean that the Contracting

Wholesaler will either seek to terminate the Wholesale Contract or subsequently terminate it. The decision remains with Wholesalers to decide if it wants to issue a termination notice within the shortened timeline.

We acknowledge that the Change Proposal as stated does not affect the maximum Wholesaler risk exposure in terms of days. However, it is our view, which was supported by some of the respondents to the consultation, that it does affect the balance of risk between the Contracting Wholesaler and Contracting Retailer. The 60:40 risk sharing ratio was developed and consulted on prior to market opening. We also note that Wholesalers are protected to some extent from the risk they bear via mechanisms in the current price control, which means the risks to Wholesalers are shared with customers. Whilst we agree the underlying principle of the Change Proposal has been well considered, we do not consider that sufficient evidence has been provided to warrant a material change to the 60:40 allocation of risk, including because this does not appear to have been the explicit focus of this Change Proposal or the consultation on it. To be clear, we are open to considering future change proposals that seek to alter the overall balance of risk between Retailers and Wholesalers. However, this is a broader issue that would need to be the explicit focus of such a change proposal and the evidence base and consultation informing it.

Our decision is to implement the reduced default timeline as proposed but amend the credit requirement reduction for those Retailers that opt in to nine calendar days rather than the 14 calendar days proposed. This still represents a reduction in the amount of collateral, which is the desired outcome of the Change Proposal, but maintains the allocation of risk between Wholesalers and Retailers. We set out below our view of how the Change Proposal impacts the risk sharing ratio, and how our amendments correct this.



Non-discrimination

We agree with the Panel's assessment. We note one respondent's view in the consultation which raised concerns about the level of credit required, citing that it is unfair and discriminatory, especially to independent Retailers. This Change Proposal offers all Retailers that have selected the Post-Payment option the choice to reduce their credit support in exchange for a reduction in the default timeline, as such we consider that it furthers the **supporting principle of non-discrimination**.

Take up of proposed solution

It is Ofwat's view that the proposed solution brings more flexibility to the market and which in turn can support the effectiveness of the market and ultimately benefit customers. We also acknowledge the view of those Trading Parties who expressed concern about the impact the change could have on their systems and processes. Whilst there will inevitably be an operational impact, none-the-less we consider that it furthers the **supporting principle of efficiency** as the design restricts opt-in frequency and therefore administrative costs, but also allows Retailers to free up capital. We agree with the Panel's assessment that ultimately it will be for the Retailer to assess any risks and benefits of opting into or out of RNPP.

Impact on currently agreed Alternative Credit arrangements

We note the Panel's views. The implementation of this Change Proposal increases the options available to Retailers regarding credit arrangements and does not dilute the ability for Trading Parties to negotiate and agree bespoke credit arrangements to reflect the specific characteristics of the Retailer and its risk profile. We still expect to see Wholesalers giving Retailer-led proposals to negotiate alternative credit arrangements due consideration where they are proposed.

We have considered the points raised in the Final Report with regards to this Change Proposal and its interaction with CPW080. We do not consider that this amendment to the WRC impacts considerations for CPW080.

Decision notice

In accordance with paragraph 6.3.7 of the Market Arrangements Code, the Authority approves this Change Proposal with the amendments as detailed above.

Georgina Mills
Director, Business Retail Market