Severn Trent Plc

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Dear Colleague,

Response on behalf of Severn Trent Water Wholesale Division:
Credit terms between wholesalers and retailers in the new retail market

We welcome the opportunity to comment on the above consultation.

We are supportive of the development of competitive markets and want to ensure the success of Non Household Retail competition. We agree with the proposed approach in this area and we are keen to work with Ofwat and other market participants to ensure the successful implementation of a pragmatic approach to these new processes. This will avoid unnecessary costs being incurred by all parties in the competitive market.

On this basis, we have made a number of points for consideration, notably around risk sharing mechanisms, which are contained in our responses to the individual specific questions as set out below.

We note that the responses contained in this document are those of the Severn Trent Water Wholesale Division only and do not represent the views of Water Plus, the Severn Trent-United Utilities Non Household Retail joint venture. Any response to the consultation made by the latter entity will be provided entirely separately to Ofwat.

Question 1

Do you have any concerns with our approach or the assumptions used in the analysis of working capital and collateral costs under different credit options? Could our analysis be improved?

We believe that the analysis is thorough, comprehensive and appropriate, and does not need to be improved further.

Question 2

Do you have any comments or concerns with our analysis of the potential impacts of different credit options against net retail margins or the conclusions from that analysis?

We have no comments or concerns.

Question 3

Do you have any comments or concerns with our analysis of the potential wholesale impacts from a major retail default or the conclusions of the analysis?

We believe that the analysis and conclusions are acceptable.
To increase the robustness of the analysis a broader default history could be used, for example credit rating agency average default rates. It is worth recognising that historic default rates may not be entirely appropriate given the potential increased default risk from BREXIT. We therefore advocate the use of a conservative stance in this area.

Question 4

Does our proposed approach of requiring retailers to provide wholesalers with 50 days of collateral through the credit arrangements represent an efficient allocation of risk? Please provide evidence to support your answer.

We consider that this is both a fair and an efficient allocation of risk and is similar to the approach taken in the UK power market DCUSA provisions.

However, we believe that further consideration should be given to the practical administration of this approach. We consider that a standard industry-wide process to administer collateral requirements could be adopted. This would provide all market participants with certainty around process and minimise costs to both wholesalers and retailers from overly-frequent changes to collateral requirements as retailer customer bases expand and contract.

We consider that this mechanism should include:

- A banding approach to collateral requirements. We assume that each retailer will have a specific numerical value which reflects its 50 days collateral requirement based on expected revenues (refer next bullet). To avoid the need for frequent changes of credit limits and the associated administrative cost and burden of managing these, we suggest that collateral requirements could be framed in £ numerical ranges. For example, Band 1: £0-£2,000, Band 2: £2,001-£5,000. In this arrangement, each retailer would need to provide collateral to cover at least the maximum limit of its credit band, for the band which includes its specific £ value requirement. This would minimise the frequency of changes required to credit limits and risk of credit breaches where wholesale charges increase each month for a growing retailer. To minimise barriers to entry for smaller retailers, bands could be stepped, with standard percentage increases. This would give the lowest bandings a relatively small absolute £ value range which would minimise working capital requirements for smaller retailers.

- A forward looking approach in respect of collateral requirements. We consider that retailers should be required to post collateral to ensure their forecast of at least the subsequent month's revenue is covered. This will avoid breaches where a retailer's customer base grows compared to the previous month, leaving a wholesaler exposed to greater than 40% of the risk.

- The trigger of a default event with all wholesalers, where retailers have insufficient collateral in any month (we suggest over an appropriate margin e.g. 90% of requirement). This can be managed in the market in the same way as late payment of an invoice by a retailer. The trigger can be re-set by an appropriate increase in the value of the collateral provided by the retailer.

Question 5

Do you support the inclusion of the six credit options set out in chapter 2?

We agree with the inclusion of all the credit options with the exception of unsecured credit.

We do not support the inclusion of unsecured credit.

We believe that the use of unsecured credit increases the proportion of risk borne by the wholesaler to greater than 40% of the total credit risk exposure in the market. We note that as an investment grade retailer can only (appropriately) obtain a maximum of 20% unsecured credit, this method requires that other credit options are used in conjunction. We believe therefore, that it is more efficient to address retailer collateral requirements fully through alternative credit options.

Question 6

Are there any changes to the proposed credit options that you consider are required and if so why? Is any further detail required in the credit arrangements for inclusion in the codes?

We consider that the following would augment the proposed credit options.

- All options – a standard industry-wide process to administer collateral requirements. (Please refer to our response to Question 4).

- Letter of credit / Third Party guarantee – Ofwat could agree and issue standard templates for each to minimise legal/administrative costs in this area for market participants.

- Insurance – Ofwat could issue a list of approved insurers, again to minimise legal/administrative costs in this area for market participants.

Question 7

Is Investment Grade Status the right threshold for assessing retailers in order for them to obtain unsecured credit? If not is there a better alternative that we should consider?

We do not support unsecured credit as a viable option. However, should it nonetheless become an option, then we would concur with the use of Investment Grade status as the threshold to make unsecured credit assessments.

Question 8

What is the minimum creditworthiness that should be required from a third party guarantor?

We believe that the minimum creditworthiness required from a third party guarantor is Investment Grade Status.

Question 9

Should Ofwat introduce a seventh credit option? What are the risks and benefits of such an option?

We believe that a seventh credit option is not required. As proposed it could potentially undermine the principle of having standard, regulated credit options.

Risks:

We believe that having bespoke credit agreements could lead to an inability of partners to reach agreement on non-standard terms.

The risk stated in the consultation document that, without this severance option, a barrier could be created to market entry, but we feel that the existing options should be sufficient. They are costly options but equally reduce risk to the wholesaler.

Benefits:

More flexibility for participants to tailor credit arrangements specific to their needs

Allows retailers to enter the market who might otherwise not be able to meet the other credit options criteria.

Question 10

Do you consider that a wholesale risk sharing mechanism should be introduced for the business retail market? Why do you consider this and what evidence can you provide to support this position?

We support the introduction of a wholesale risk-sharing mechanism (RSM). In our view this has the potential to improve the efficiency of market arrangements and reduce overall costs to customers.

As stated above we are supportive of the credit arrangements that have been put forward which involve a sharing of risk between wholesale and retail. We understand that providing full protection to wholesalers (via payment in advance) could be a barrier to retail entry, which is why Ofwat has developed a range of credit options. However, leaving wholesalers with no protection against credit risk in the competitive market, would introduce additional costs within the value chain. This would not benefit customers.

Before separation, the wholesale functions had no risk associated with their retailers, which were ultimately part of the same company. At PR14, no provision is made for bad debt, or for the costs associated with credit management, in the wholesale totex allowances.

The whole of these costs were allocated to retail. Creating an additional set of credit management functions in wholesale would therefore be an inefficient duplication of activity.

There is a remote risk that wholesalers have no regard to the credit standing of retailers – i.e. if wholesalers believed they would recover funds from other customers regardless, they might be willing to enter into agreements with retailers whose finances are not robust without challenge. However, wholesalers do have an incentive to manage their cash flow. If the risk sharing mechanism does not allow recovery for up to 5 years, there is a strong incentive to be prudent in retail arrangements. We think that the RSM should complement the other arrangements in place (i.e. the provision of collateral).

We do not think that the existing routes for risk mitigation (such as IDOKs and the Substantial Effects Clause) would be suitable in this situation. Designating retailer default as a notified item for the purpose of an Interim Determination (IDoK) is unlikely to offer any protection: a default is unlikely to be sufficient by itself and thus the company would need a number of other claims in order to recover the money. A materiality threshold of 1% of wholesale revenue would also be too high in this market, noting that this is a market which will look to encourage new retail entrants, some of whom may be relatively small. The requirements under the Substantial Effects Clause are even more onerous.

Question 11

What could be the potential impact of wholesale risk sharing on new entrants and market competiveness?

We regard a wholesale risk sharing mechanism as a complementary tool and one which will not remove risk from retailers.

Use of an RSM has the potential to broaden the number of retailers that could enter the competitive market, as credit would not be such a barrier.

We believe that this mechanism will improve the efficiency of the whole credit arrangement as costs are not duplicated.

Question 12

If a wholesale risk sharing mechanism were introduced, how should it interact with the proposed credit options?

We believe that the wholesale risk sharing mechanism as complementary to the credit options, as the last option for debt recovery in case of default.

Question 13

We welcome your views on the specific features of a risk sharing mechanism (should one be introduced), covering: triggers, materiality, justification and evidence, coverage, exclusions and caps, burden of recovery, timings, process, administration and order of recovery and practicality and costs.

We propose a simple form of Risk Sharing Mechanism (RSM):

- Wholesalers should be able to submit a claim at periodic reviews for income that has not been collected because of retailer default.

- Funds that can be recovered in some other way should be deducted from the submission. This would include the collateral provided by the retailer, and any cash that has been claimed back from the retailer's administrators as a result of normal insolvency procedures.

We believe that the 40% cap is unnecessary – it is somewhat arbitrary and is essentially reflecting the proper application of these processes (given the split of risk between retail and wholesale represented through the 50 day collateral requirement).

We agree that the cost of the RSM, when included in wholesale price limits, should be allocated wholly to non-household customers. This would be the same as the Open Water costs which were included at PR14.

The alternative is that the wholesaler carries bad debt risk. Under this approach, wholesalers will have to start providing for bad debts within their accounts, and carrying the cost of credit management functions. This cost will ultimately be borne by customers.

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Question 14

Do stakeholders have any concerns with our proposed next steps and timescales for resolving the outstanding credit arrangements?

We have no concerns and agree with the timescales proposed.

Please do not hesitate to contact me should you require information on any of the points covered.

Yours sincerely

A J Ball

Dr Tony Ballance
Director, Strategy & Regulation