**Credit and Collateral Arrangements Review – Call for Inputs**
**April 2025**

<u>Executive Summary</u>
We welcome the opportunity to respond to the Call for Inputs on Credit and Collateral Arrangements, which are a critical aspect of the market's operation.

There are a number of elements of the current arrangements which have worked well and should be maintained in any new arrangements. These include:

- The variety of instruments on offer to provide flexibility
- The existence of reductions in collateral for trading parties from strong creditworthiness
- The aim of transparency of bespoke or bilateral arrangements between trading parties
- The bespoke arrangements offered by wholesalers (which have supported initial market entry across most regions)

Whilst these elements are strengths of the current regime, there are key aspects which require reassessment, specifically the balance of risk and Parent Company Guarantees.

The arrangements are important to ensure an appropriate balance of risk between trading parties to support market stability and encourage market entry and a competitive landscape. At the inception of the market, Ofwat selected conservative assumptions in respect of the probability of default, which at the time made sense in the context of ensuring market stability for wholesalers. With the market having developed over the past eight years and demonstrated significant resilience across a number of global events, now is a good opportunity to revisit the assumptions which underpin the arrangements, and to seek a more balanced position which supports the aims Ofwat has set out.

At the outset of the market, the majority of trading parties were associated with one or more wholesalers in one form or another. Parent Company Guarantees provided stability and reduced costs for groups at this early stage of the market. We believe that the current rules around PCGs are insufficient to ensure a level playing field, and place unassociated retailers at a competitive disadvantage both in respect of the commercial arrangements of these PCGs, but also overall capital structures. We would encourage Ofwat to explore further issues related to the transparency of arrangements and also the commercial impact of these arrangements on trading parties.

<u>Detailed Responses</u>
**Q1 Do you consider the above impacts to accurately capture how credit arrangements support good customer outcomes?**

- **Do you disagree with any of the impacts we outline?**
- **Are there any other impacts we should consider when looking at credit security arrangements?**

We agree with the impacts presented, and do not have any additional comments to make.

**Q2 Noting market evolution and developments since market opening, do you consider credit support arrangements remain appropriate in the business retail market? Please provide views or evidence to support your views.**

- **Do your views here apply to both backstop and negotiated arrangements? If not, please explain any differences and the reasons for this.**

We believe that the current arrangements achieve some of the market aims which are set out. The variety of arrangements offered, and the benefits obtained from bespoke arrangements are both areas which facilitate good customer outcomes.

Having said that, the current arrangements are one of the most significant barriers to entry in the non-household market. The CFI correctly identifies the need to balance risk between trading parties, but the evidence suggests that the combination of lower margins and high collateral requirements has dissuaded new entrants from entering the market to compete both at the large and small ends of the market.

One of the reasons why Everflow decided to focus on SME customers was due to the high cost of working capital requirements for I&C customers, with the main area of impact being the upfront collateral required. This challenge has prevented us from competing for and winning contracts worth tens of millions annually (with specific examples we can provide of where we would have won contracts had the collateral requirements not been as onerous).

The balance of risk is a key area to explore. At the outset of the market, there was a particular concern to ensure that the wholesale market was not destabilised as a result of the opening of the non-household market, and therefore the balance of risk was set up to ensure sufficient protection. Evidence both from other markets with a higher risk profile and trading performance of trading parties in the non-household market indicates that the risk profile for this market is lower than the current arrangements result in, and therefore this should be explored further. We provide evidence on this in our response to Q6.

If the arrangements present a significant barrier to entry, then facilitating increased market entry (whilst ensuring sufficient protection for wholesalers and ensuring retailers are not incentivised to overcommit as described in the CFI) should lead to greater opportunities for innovation and growth across the market, ultimately leading to better outcomes for customers.

**Q3 Do you see any particular areas of strength or weakness in the current arrangements? For example, noting the balance of risks, are current arrangements sufficiently attuned to:**

- **Retailer interests and circumstances - particularly regarding the need for any credit security arrangements and obligations to minimise costs of entry and operation?**

- **Wholesaler interests and circumstances - particularly regarding the need for any credit security arrangements to ensure Wholesalers are not exposed to an inappropriate degree of risk?**
- **Customers' interests and circumstances – particularly whether the best interests of customers are being promoted?**

See our response to Q2 for comments on the above, particularly how the interests of customers can be better served by the arrangements.

On the assumption that cash security remains an option in any revisions to this area, it is important to retain the link to Bank of England base rate within the codes for the cash deposited with wholesalers. This is consistent with treatment of cash deposits in other sectors (rent deposits for example), and ensures that the value of cash held is not eroded by inflation over time. At different points in the economic cycle, the interest rate will be higher or lower than inflation, but over time these should even out.

**Q4 Do you consider these areas of focus to be appropriate?**

- **If not, what should we be considering and why?**
- **Are there any sources of evidence / information which you consider to be particularly important as we review the effectiveness of credit security arrangements?**

We believe these to be appropriate.

**Q5 Do you consider the aims and objectives of our review to be appropriate?**

- **Are these the right aims and objectives?**
- **Are there any aims and objectives which are inappropriate?**
- **Are there any other factors that should be considered – if so, why?**

We believe these to be appropriate. In particular, we welcome the focus on encouraging customers to engage with the non-household market and supporting a seamless experience for them. Customers should be able to benefit from a highly competitive market, and reviewing the arrangements to encourage competition is an important activity.

**Q6 What do you think the backstop allocation of risk between parties should be? Do you consider that the 60/40% allocation remains appropriate? Please provide views or evidence to support your views.**

We do not believe that the backstop allocation remains appropriate.

The non-household market has seen two defaults in the eight years since the market opened (Tor Water and Aquaflow), both of which served under 300 supply points, and therefore the financial impact was limited. In that time, the market has operated through a global pandemic, a cost of living crisis and other significant world events impacting on the economy, and to date no large or medium-sized retailer has failed. We are not party to the responses to Ofwat’s Financial Resilience RFIs, but if as we would hope, these present a strong and improving picture over the past few years since the pandemic, then this provides further indication of the financial health and resilience of the non-household market.

Similarly, in Scotland there have been minimal defaults in what is a similar market with similar features in respect of market participants.

The market arrangements for collateral are similar in nature to DCUSA with regard to the 60:40 risk allocation. The electricity market is a market which has presented a far higher level of risk and default over the past 10 years when compared to the water sector.

In the original decision document, Ofwat's decision was stated as being conservative:

> *"The 1 in 20 probability of default is based on the average impacts of defaults in Scotland (0.08%) and UK energy (0.02%) and the UK insolvency rate of ~0.5%. We acknowledge that our assumptions may be conservative, but we think this represents a realistic upper-end assumption on the risk of default and remain of the view that the impact will be minimal."*

At the time there was limited evidence as to how the market would operate, what competition would look like and how retailers and wholesalers would interact. Now that the market is established and stable, we believe that a more balanced approach to the backstop position is appropriate. We believe that the backstop position should be 40/60%, reflecting the lower risk profile of the market and the level of comparative volatility with comparator markets.

**Q7 Do you agree that comparisons with other sectors will be useful in informing our review of credit security arrangements and risk allocation? How should these comparisons be undertaken and used?**

Comparisons with other sectors should be used in informing the review of arrangements. The various energy markets were reviewed in 2016, and we believe these should remain in scope for comparison, noting that evidence now obtained from 8 years of the market provides a better ability to compare the relative volatility of both markets and how this impacts on collateral requirements.

In certain other sectors, there are allowances for no collateral to be provided where companies can evidence a strong track record of payment performance and creditworthiness (not just in the case of an investment grade credit rating). We believe that more consideration should be given to the level of unsecured credit available for retailers where they can demonstrate this track record over a number of years, as this should reduce costs for customers and further encourage innovation.

**Q8 Do you have any information or evidence to inform our modelling how the costs of credit security arrangements impact on Wholesalers or Retailers? We welcome comments on any aspect of this work including:**

- **The inputs, assumptions and scenarios we use when modelling costs;**

- **The benchmarks we use to understand how modelled costs may impact on companies.**

Ofwat now has detailed financial resilience information on existing retailers, which should inform the likelihood of retailer insolvency. These should be utilised to help form a view on the likelihood of default.

**Q9 Do you consider there to be any sources of evidence that might be particularly useful in informing our review of risk allocation? Please explain why you consider this source of evidence to be appropriate.**

As highlighted in Q7, comparisons to other sectors would be appropriate, in conjunction with comparing the level of risk and stability in the respective markets.

We believe that the cost of debt should also be reviewed as part of the assessment, noting that the initial review included a cost of 8%, where debt financing costs have risen significantly since the initial review in 2016, and the availability of equity financing is also lower than at the time of the initial review in 2016 as a consequence of higher interest rates, increased market caution (particularly around the water sector) and muted capital markets activity.

**Q10 Do you consider that a selection of backstop credit security options remains appropriate? Please explain your reasons for your view including any supporting information and evidence where appropriate.**

We believe that the selection of arrangements remains appropriate.

**Q11 Do you have any concerns over the current range of backstop credit security options – are there any instruments you would like to see considered for inclusion or exclusion? What are the reasons for this?**

There are no other instruments we would suggest be included or excluded.

Whilst we do not currently hold letters of credit or surety bonds, we would note that as a retailer operating across all wholesale regions and growing each month, we observe the potential for significant administrative burden from maintaining multiple letters of credit or surety bonds with different wholesalers, particularly given the reality that a default with one wholesaler constitutes a default with all wholesalers. In this context, consideration could be given to whether there is a mechanism to simplify how these instruments would work across the market to ensure administrative simplicity for retailers and wholesalers whilst retaining security.

**Q12 Do you have any concerns about the use of PCGs? If so please outline your concerns and provide supporting views or evidence – for example, that the principles we outline above are no longer relevant or are not being met?**

We retain long-held concerns around the use of PCGs.

It is important to highlight that provision of credit support cover is part of a retailer's overall capital structure, in particular where guarantees or insurance instruments are not accessible. From a financial perspective, some of the instruments available as credit security are debt instruments (letters of credit, cash funded through debt), whilst others are not (surety bonds, PCGs). Utilising debt as a form of credit security is a valid commercial choice, but opting for this is a choice which reduces the debt capacity of a business to raise additional funding to invest in growth and fund working capital. Where a business uses surety bonds or PCGs, this means that the business retains debt capacity for other uses. Whilst PCGs may be set at a commercial and arm's length rate, this assumes that the business would have been able to obtain this funding from a third party in addition to its existing lending, and in some cases other intragroup funding would be subject to the same considerations.

Based on statutory account disclosures, it is also not clear whether retailers with PCGs in place are being charged either at all, or at a commercial rate.

We ask Ofwat to look at this area in greater detail as part of the scope of work.

**Q13 If you are a Retailer, which credit security option(s) do you use and what factors are important in driving this decision?**

Everflow currently posts cash with wholesalers as collateral. The factors driving this decision are:

- Availability of other alternatives – as an unassociated retailer, PCGs are not an option (and as articulated in Q12 we remain of the view these are anti-competitive), and our historic experience has been that for a growing business of our size and scale, surety bonds are not an option, and letters of credit on offer from high street banks and alternative lenders have either required a significant element of cash backing (100% in most cases) or would have been prohibitively expensive to customers given pricing would have reflected this. We are happy to share evidence directly with Ofwat of examples.
- Existing lending structure – as with our response to Q12, letters of credit are debt instruments which would have had to sit alongside investment from our current investors and lenders, and our existing security structure precluded this as an option.
- Benefits to customers – by choosing cash, we were able to offer discounts to customers through reduced lending costs.

**Q14 Do you consider the assumptions and design features informing the use of credit security options to remain appropriate? What changes would you like to see explored as part of this review and what evidence is there to support this work?**

As we currently utilise cash security, we do not have as detailed evidence on the actual costs included for some of the other items. Elsewhere in our response we have highlighted some of the assumptions that may need further exploration, in particular the cost of debt and the cash-backed requirement for some letters of credit.

**Q15 Do you agree that exploring the level of bespoke negotiated arrangements should be a priority for this review? Please explain your reasons for this and include any information / evidence that may inform our work.**

We do not believe that exploring the level of bespoke negotiated arrangements should be a priority for the review.

We were pleased to see the range of options offered by wholesalers following the 2018 review of credit arrangements, and these have been beneficial to the market as a whole and to us as an unassociated retailer, particularly in the early years of trading where as a smaller retailer and new entrant these arrangements helped us establish a presence in specific wholesale regions. We also welcome the recent updates to reflect increases in wholesale charges.

Whilst we welcome these arrangements and believe they should be retained to benefit the market and encourage new entrants into the market, we believe that reviewing the backstop arrangements and ensuring an appropriate balance of risk is a higher priority which would best serve customers.

**Q16 Do you agree that looking at the competition aspects of bespoke arrangements should be a priority of this review? Please explain your reasons for this and include any information / evidence that may inform our work.**

We do not believe that reviewing the competition aspects of bespoke arrangements should be a priority. Our experience is that for the most part, arrangements between trading parties have been made available to all parties on a consistent basis. Where this has not been the case, we have understood the reasons why credit was made available to some but not other trading parties.

**Q17 Please outline any other issues you would like to see explored in relation to negotiated credit security arrangements. If so, please include your reasoning for why this issue is important and include any information / evidence that you may have to inform this work.**

N/A

**Q18 Do you have any views considering the processes / features determining how credit security arrangements are implemented and operated?**

- **Are the current processes / features appropriate in supporting credit security arrangements being implemented and operated in a manner consistent with the aims and objectives of our review?**
- **Are there areas that can be improved? If so, why are such changes important?**

Having raised a code change in this area which was ultimately approved, and then having worked through the implementation of the change within the market in detail, we believe that the processes around implementation and operation of the arrangements have performed well and that trading parties have worked together to ensure that this area of the market works largely as expected.

We would however note that due to the manual nature of the processes for a number of wholesalers, the potential for manual errors within calculations is higher than in other areas of the market (which is potentially in part due to the volume of bespoke arrangements in place and the sophistication or otherwise of processes in this area). We have robust controls in place to ensure that calculations are validated prior to payment, but this may not be the case across the market.

**Q19 Do you have any views regarding the efficacy of transparency requirements?**
- **Are the current requirements working as intended?**
- **Are there any additional requirements you think might be appropriate?**

The principle of transparency arrangements within the market serves an important purpose in supporting a level playing field across retailers and providing visibility of what arrangements are being offered by wholesalers.

Whilst the principle of the arrangements is welcome, as highlighted in the response to Q12, transparency around the existence of PCGs is only part of the issue. There should also be consistency between market-related disclosures and those contained within statutory accounts, as well as how the PCGs are applied commercially. For example, one retailer has guarantees in place which are disclosed within the statutory accounts as having a value ascribed to it, but that no charge was made to the retailer for the guarantees.

Whilst these companies are part of a wider group with financial strength, the financial strength arises out of the fact these groups contain wholesale water companies, and therefore this confers an advantage on them which is not available to all competitors. Ultimately, a level playing field would mean that the funding retailers obtained from group companies would be available to them on the same terms from third party sources (including guarantees but also other group funding). From the information which is publicly available, it is not always clear that this is the case.