

Alternatives to pre-payment under the Wholesale Services Agreement including the use of guarantees

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This paper sets out details of the Water Industry Commission for Scotland's policy to allow applicants for water services and sewerage services licences to choose other methods for the payment of their wholesale charges to Scottish Water rather than prepayment, including the use of a guarantee.

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Background

Since 8 January 2007 potential new entrants to the competitive market for non-household customers have been able to apply to the Water Industry Commission for Scotland (the **Commission**) for water services licences and sewerage services licences¹. As at the beginning of May 2009, we have granted licences to five companies (known as **licensed providers**)².

Under section 7(1) of the Water Services etc. (Scotland) Act 2005 (the **2005 Act**), for each licence application the Commission may only grant a licence "*if satisfied that the applicant has the ability to perform adequately the activities authorised by the licence.*" Section 7(2) of the 2005 Act also sets down specific factors to which the Commission must have special regard when assessing an applicant's ability to perform those activities. Those factors include the applicant's:

- "(a) knowledge, expertise and experience; and*
- (b) financial acumen and business viability."*

To comply with the requirements of the 2005 Act, we have published both an application form and guidance as to the application process as well as the assessment criteria we will use when considering whether to grant a licence. The form and application guidance can be found on our website³.

We have also published our policy statement on the approach to the development of the retail market in Scotland⁴. The requirement to have regard to "*financial acumen and business viability*" is reflected in our policy statement which sets out that all applicants "*will have to demonstrate financial viability*" and "*will have to provide evidence either that they have a commercially robust capital structure ... or that they can rely on third party financial support.*"

In addition to the initial requirement to demonstrate financial viability as part of the application process, licensees have been required, under the terms of their wholesale services agreement (**WSA**)⁵, to make payment of the Provisional Monthly Charge⁶ by the

¹ Part 2 of the Water Services etc. (Scotland) Act 2005 commenced on 8 January 2007, to the extent it had not commenced previously.

² Scottish Water Business Stream, Ondeo Industrial Solutions, Osprey Water Services, Satec and Aimeria.

³ www.watercommission.co.uk/view_Licence_Application.aspx.

⁴ "Development of the Scottish retail market: A policy statement". This can be found on our website: www.watercommission.co.uk/view_Market_Documents_Comp.aspx.

⁵ The WSA is the contract between a licensed provider and Scottish Water (the wholesaler) for the provision of wholesale water and sewerage services within the competitive market. For further details on the WSA, please refer to our website, www.watercommission.co.uk.

tenth business day prior to the start of each month. This prepayment arrangement has applied to all licensed providers and reflects the Commission's policy that all participants in the market must continue to demonstrate financial viability moving forward from the initial licence grant.

Under Standard Licence Condition A7, all licensed providers must enter into a WSA approved by the Commission. The Commission has drafted a template WSA, which is the default contract for the provision of wholesale water and sewerage services from Scottish Water to each licensed provider. The template WSA has codified the Commission's requirement under the licence application process for licensed providers to agree to prepay their wholesale charges⁷ through a Provisional Monthly Charge.⁸ After a licensed provider has prepaid for a particular month, several reconciliation runs are then carried out by the CMA and balancing payments to/from Scottish Water paid subsequently⁹.

Alternative methods of payment

In exercise of its powers under Standard Licence Condition A7 (wholesale services agreement)¹⁰, the Commission has recently considered its approach to ensuring the continuing financial viability of licensed providers and has decided that it is appropriate to modify the template WSA in order to offer future license applicants (and current licensed providers) the option to negotiate with Scottish Water to use alternatives to prepayment such as the use of a guarantee.

The Commission has decided to allow the use of alternatives to prepayment as a result of the increasing maturity of the competitive market since its opening in April 2008 and the changes that have taken place within the credit markets over the last 12 months.

By allowing applicants to negotiate alternatives such as the use of a guarantee, the Commission believes it should be possible to avoid prepayment becoming perceived as a barrier to entry into the competitive market (given the cash flow pressure that could result from prepayment), whilst ensuring that Scottish Water is not placed in a position that is financially less secure or carries additional risk. In this regard the Commission has been mindful of its obligations under section 11(1) of the 2005 Act to exercise its functions

⁶ Clause 8 of the template WSA deals with terms of payment for the wholesale services provided by Scottish Water and includes the requirement under clause 8.2 to make payment of the Provisional Monthly Charge in advance of each month. This arrangement is referred to in this paper as "prepayment".

⁷ See clause 8.2 of the template WSA.

⁸ Clause 8.1 of the WSA states that the Provisional Monthly Charge "*shall be an amount payable by the Licensee as set out in the Settlement Report sent by the Central Market Agency to SW and the Licensee, in respect of the provision of Services during Month X*".

⁹ Clause 8.3 of the WSA.

¹⁰ Paragraph 6 of Standard Licence Condition A7 enables the Commission, following such consultation as may be appropriate, to issue directions providing that any WSA shall have effect with or subject to such modifications as are specified in those directions. A contractual mechanism has been included in the WSA at clause 24.5 to enable such modifications.

relating to water services and sewerage services licences *"in a manner that is not detrimental to the exercise of Scottish Water's core functions"*.

In light of the Commission's decision, we set out below the details of how alternatives to prepayment may now be utilised within the competitive retail market.

Licence applications

Applicants for both water services and/or sewerage services licences (including applicants for self-supply and specialist licences) may choose when applying for their licence(s) whether they want their payment terms under their WSA to be based on:

1. prepayment of the provisional monthly charge before the start of the month in which the services are being provided, together with a balancing payment to/from Scottish Water paid subsequently; or
2. payment of the provisional monthly charge by an alternative method such as payment by a date agreed with Scottish Water, secured by a guarantee to Scottish Water.

The guarantee in option 2 above will cover all sums owed by the licensed provider to Scottish Water under the market framework arrangements, including the cost to Scottish Water of any recovery of unpaid wholesale charges.

When applying for licence(s), an applicant who wishes to use an alternative to prepayment will be required to provide the Commission with evidence that it is financially viable. If an applicant wishes to use a guarantee then this evidence will include showing that its proposed guarantor has a suitable credit rating (see below) and is willing to provide the guarantee. If an applicant is unable to provide this evidence then it will be required to prepay the provisional monthly charge (and may also be required to use an Escrow Agreement)¹¹.

To ensure a level playing field within the market, if an applicant has been granted a licence on the basis that it will prepay its wholesale charges it may subsequently move to an alternative (at a time of its choosing) if it is able to obtain the appropriate evidence of continued financial viability, i.e. it can obtain a guarantee from a suitable guarantor¹². Accordingly, current licensed providers¹³ may choose to move from prepayment to an

¹¹ For further details see the Commission's licence application guidance, and in particular the section entitled "Evidence of financial viability".

¹² It should be noted that Standard Licence Condition A9 provides: *"the licensee shall not receive, or procure the receipt of, financial support from another market participant..."*. This Condition provides that *"financial support"* shall include a guarantee. Accordingly, neither market participants nor applicants will be permitted to obtain a guarantee from any other market participant.

¹³ As at the beginning of May 2009 these companies are Satec, Business Stream, Ondeo Industrial Solutions, Osprey Water Services and Aimera.

alternative at any time, once they are able to provide evidence of continued financial viability to the Commission.

Restrictions

1. Discretion of the Commission

The Commission noted in its consultation paper that it did not intend to allow licensed providers who hold a dominant position in the overall market for retail water and sewerage services to use an alternative to prepayment such as the use of a guarantee.

Our intention behind that proposal was to ensure that the Commission would have the ability to refuse the option of an alternative to prepayment such as the use of a guarantee where the Commission is of the view that the market share of a licensed provider is such that if the requirement for prepayment were removed, this might present a risk to the exercise of Scottish Water's core functions¹⁴ and therefore the operation of the retail market. Prepayment not only allows the Commission to ensure the continuing financial viability of licensed providers, it also provides an "early warning" mechanism of failure by a licensed provider. The concept of "dominant position" under competition law is not necessarily the only way of framing that test.

In light of comments received, the Commission has decided that it will reserve the right to refuse the use of an alternative to prepayment such as the use of a guarantee where it considers that given all the facts and circumstances of each individual case, it is not in the best interests of the market. Three important elements that we will consider when making this decision are:

- (1) market share;
- (2) the number of licensed providers active in the market; and
- (3) the financial risk that would attach to Scottish Water should the licensed provider fail such that, in the Commission's view, that failure could be detrimental to the exercise of its core functions.

2. Minimum credit rating

Where a licensed provider wishes to use a guarantee as an alternative to prepayment, to ensure that guarantee is sufficient to meet the licensed provider's obligations within the competitive market, the Commission has determined that any guarantor must have a minimum investment grade credit rating.

¹⁴ Section 11(1) of the 2005 Act.

The Commission has determined that the investment grade credit rating for guarantors at this time should be an 'A' rating¹⁵. This rating would be kept under review by the Commission from time to time.

The guarantor must maintain its minimum investment grade credit rating at all times. Should the guarantor's credit rating fall below the minimum required by the Commission or should the guarantor no longer subscribe to the rating agencies¹⁶, the licensed provider in whose favour the guarantee was given must inform the Commission immediately. The licensed provider will then have 30 business days from the date on which the change or loss of credit rating took effect to obtain a replacement guarantee from a new guarantor.

If the licensed provider is unable to obtain a replacement guarantee within the allowed 30 business days, the Commission will provide the licensed provider and Scottish Water with a Modification Notice under clause 24 of the relevant WSA requiring the licensed provider to prepay its wholesale charges.

Payments to Scottish Water

1. Date of payment

Where a licensed provider chooses to use an alternative to prepayment such as the use of a guarantee, it will be able to negotiate when it wishes to pay its Provisional Monthly Charge to Scottish Water.

Each licensed provider may therefore negotiate with Scottish Water for a payment date that is any date forward from the due date for prepayment (currently ten Business Days from receipt of the invoice for the relevant month).

2. Interest

Where a licensed provider prepays the Provisional Monthly Charge, Scottish Water pays interest to that licensed provider¹⁷. However, where an applicant chooses to use an alternative to prepayment such as the use of a guarantee, dependent on when that applicant chooses to pay Scottish Water the Provisional Monthly Charge interest may be due to Scottish Water from the applicant.

¹⁵ The Commission has not specified from which ratings company a guarantor's rating should originate. Accordingly, the appropriate rating from any of Moody, Standard and Poor and Fitch IBCA shall be suitable.

¹⁶ i.e. any of Moody, Standard and Poor and Fitch IBCA.

¹⁷ At the published base lending rate from time to time of Bank of Scotland. For the purpose of calculating such interest, the Provisional Monthly Charge is treated as due in equal daily installments as wholesale services are provided during the month to which the Provisional Monthly Charge relates. From the date when the Provisional Monthly Charge is due, interest is calculated on the full amount due. Thereafter interest is calculated on the reducing balance where the balance reduction reflects the payment of the daily installment on each day. See clause 8.8.2 of the template WSA.

Interest will continue to be calculated in the same way, i.e. the Provisional Monthly Charge is treated as due in equal daily instalments as wholesale services are provided during the month to which the Provisional Monthly Charge relates.

Accordingly, should a licensed provider continue to pay the Provisional Monthly Charge in advance of the beginning of the month, Scottish Water will pay interest on the entire amount from the date of payment to the beginning of the month. Thereafter, Scottish Water will pay interest to the applicant in the usual way¹⁸.

However, should a licensed provider choose to utilise an alternative to prepayment (such as the use of a guarantee) and thereby have the option to pay after the beginning of the month to which the Provisional Monthly Charge relates, Scottish Water and the applicant will pay interest to each other based on the balance owed to Scottish Water on the day of payment, where the balance reduction reflects the payment of the daily installment. Accordingly, should a licensed provider agree a payment date with Scottish Water that is after the end of the month to which the Provisional Monthly Charge relates, the licensed provider will pay interest on the entire amount from the end of the month until the payment date.

Amendments to the market framework documents

To effect the changes set out above, the Commission has modified the template WSA. To avoid over-complication, there will be two template WSA, one for applicants who intend to prepay and are not required to use an escrow account and another for those applicants who do not wish to prepay or who are required to use an escrow account.

Current licensed providers will be able to choose to modify their existing WSA by submitting a Modification Notice to the Commission¹⁹.

The Commission has also amended the licence application form and guidance as to the application process to reflect the changes to the template WSA.

**Water Industry Commission for Scotland
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¹⁸ Interest will be paid by Scottish Water to the applicant under clause 8.8 of the template WSA. This is paid on the reducing balance of the Provisional Monthly Charge where the balance reduction reflects the payment of the daily installment on each day.

¹⁹ Pursuant to clause 24 of the WSA.