

Title: Introduction of a Special Administration Regime for Electricity and Gas Supply Companies Lead department or agency: DECC Other departments or agencies:	Impact Assessment (IA)
	IA No: DECC0020
	Date: 09/12/2010
	Stage: Final
	Source of intervention: Domestic
	Type of measure: Primary legislation
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Summary: Intervention and Options

What is the problem under consideration? Why is government intervention necessary? Current arrangements to deal with the insolvency of gas and electricity suppliers allow Ofgem to revoke the supplier's licence and appoint another supplier to take over its customer accounts. There is a significant risk they would not be effective in dealing with the insolvency of large suppliers because of the large volume of customers involved. Customers would continue to be supplied at potentially greater cost with energy bought through the imbalance mechanisms rather than under contract. This would put industry systems under strain, reduce stability in the market, risking contagion. Government intervention is therefore necessary to ensure that there is an adequate 'insurance policy' in place for this low probability, high impact event.	
What are the policy objectives and the intended effects? The policy objective is to put in place arrangements to ensure that if a large energy supplier became insolvent : <ul style="list-style-type: none"> - its customers would continue to be supplied as cost effectively as possible; - any impact on the industry systems, particularly balancing and settlement, arising from, large, unpredictable transfers of costs from a failed supplier to other industry participants, are minimised - market stability and customer confidence is maintained 	
What policy options have been considered? Please justify preferred option (further details in Evidence Base) Three options have been considered. We considered doing nothing. However, the costs of supplying the failed company's customers would be greater and would be transferred in an unpredictable way to other industry participants and we expect ultimately to all consumers. It would increase uncertainty and instability in the market, with the risk of contagion effects. A second option was to consider systems or code changes. This option was not explored in detail as it was clear from the outset that it would result in up-front costs being incurred by industry participants and could not be relied upon to provide sufficient funding in all circumstances. Our third and preferred option is to introduce a Special Administration Regime for electricity and gas supply companies. Should a company become insolvent, no buyer can be found and it is not possible to appoint a Supplier of Last Resort, the chosen option allows the company to continue to supply customers, while offering the least disruption to the market and limiting any risk of contagion.	
When will the policy be reviewed to establish its impact and the extent to which the policy objectives have been achieved?	It will not be reviewed unless it is used
Are there arrangements in place that will allow a systematic collection of monitoring information for future policy review?	Not applicable

Ministerial Sign-off For final proposal stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) the benefits justify the costs.



Signed by the responsible Minister:

..... Date:09/12/2010.....

Summary: Analysis and Evidence

Policy Option 1

Description:

Preferred Option: Introduce a Special Administration Regime for Electricity and Gas Supplier Companies

Price Base Year 2009	PV Base Year 2009	Time Period Years 20	Net Benefit (Present Value (PV)) (£m)		
			Low: -0.070	High: 0.177	Best Estimate: 0.055

COSTS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	0.07		0.07
High	0.07		0.07
Best Estimate	0.07		0.07

Description and scale of key monetised costs by 'main affected groups'

Government and Ofgem will experience a one-off administrative cost to introduce the regime and some administrative costs if the regime were used.

Other key non-monetised costs by 'main affected groups'

There is the potential for the introduction of a Special Administration Regime to result in an increased cost of capital for supply companies, however for reasons explained in the Evidence Base we do not expect this to materialise. The Balancing and Settlement Panel and Energy Balancing Credit Committee may have to introduce small consequential amendments to the codes governing the balancing and settlement mechanisms.

BENEFITS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low		N/A	0
High		N/A	0.247
Best Estimate		N/A	0.125

Description and scale of key monetised benefits by 'main affected groups'

In the event of the failure of a large supplier, Special Administration would lower the short run cost of supplying energy to customers of the insolvent company of approximately £1.5m. This figure has been weighted by the probability of default to present a net benefit of the introduction of SAR of between £0 and £247k.

Other key non-monetised benefits by 'main affected groups'

In the event of such a failure, a Special Administration Regime would also limit the impact of large and unpredictable transfers flowing from the insolvent company to other market participants due to the provision of energy to customers of the insolvent company. The regime would also reduce the risk of contagion and market destabilisation as market and consumer confidence is maintained by the existence of the Special Administration Regime.

Key assumptions/sensitivities/risks

Discount rate (%) 3.5%

The estimates reflect the price of providing energy to the customers of an average large energy supplier. The figures would vary depending on the actual size of the supplier and its customer base, the price of energy at the time of the insolvency, the market reaction and any potential risk premium, and the length of time the company was in administration. The estimates also assume that a trade sale of the failing company would not be possible, and that Ofgem would be unable to appoint a Supplier of Last Resort.

Impact on admin burden (AB) (£m):		Impact on policy cost savings (£m):		In scope
New AB:	AB savings:	Net:	Policy cost savings:	Yes/No

Enforcement, Implementation and Wider Impacts

What is the geographic coverage of the policy/option?	Options				
From what date will the policy be implemented?	Summer 2011				
Which organisation(s) will enforce the policy?	N/A				
What is the annual change in enforcement cost (£m)?	N/A				
Does enforcement comply with Hampton principles?	Yes/No				
Does implementation go beyond minimum EU requirements?	N/A				
What is the CO ₂ equivalent change in greenhouse gas emissions? (Million tonnes CO ₂ equivalent)	Traded: N/A		Non-traded: N/A		
Does the proposal have an impact on competition?	No				
What proportion (%) of Total PV costs/benefits is directly attributable to primary legislation, if applicable?	Costs:		Benefits:		
Annual cost (£m) per organisation (excl. Transition) (Constant Price)	Micro 0	< 20 0	Small 0	Medium 0	Large 0
Are any of these organisations exempt?	No	No	No	No	No

Specific Impact Tests: Checklist

Set out in the table below where information on any SITs undertaken as part of the analysis of the policy options can be found in the evidence base. For guidance on how to complete each test, double-click on the link for the guidance provided by the relevant department.

Please note this checklist is not intended to list each and every statutory consideration that departments should take into account when deciding which policy option to follow. It is the responsibility of departments to make sure that their duties are complied with.

Does your policy option/proposal have an impact on...?	Impact	Page ref within IA
Statutory equality duties ¹ Statutory Equality Duties Impact Test guidance	No	
Economic impacts		
Competition Competition Assessment Impact Test guidance	No	
Small firms Small Firms Impact Test guidance	No	
Environmental impacts		
Greenhouse gas assessment Greenhouse Gas Assessment Impact Test guidance	No	
Wider environmental issues Wider Environmental Issues Impact Test guidance	No	
Social impacts		
Health and well-being Health and Well-being Impact Test guidance	No	
Human rights Human Rights Impact Test guidance	No	
Justice system Justice Impact Test guidance	No	
Rural proofing Rural Proofing Impact Test guidance	No	
Sustainable development Sustainable Development Impact Test guidance	No	

¹ Race, disability and gender Impact assessments are statutory requirements for relevant policies. Equality statutory requirements will be expanded 2011, once the Equality Bill comes into force. Statutory equality duties part of the Equality Bill apply to GB only. The Toolkit provides advice on statutory equality duties for public authorities with a remit in Northern Ireland.

Evidence Base (for summary sheets) – Notes

Use this space to set out the relevant references, evidence, analysis and detailed narrative from which you have generated your policy options or proposal. Please fill in **References** section.

References

Include the links to relevant legislation and publications, such as public impact assessment of earlier stages (e.g. Consultation, Final, Enactment).

No.	Legislation or publication
1	<u>SAR for Energy Network Companies IA (2004)</u>
2	
3	
4	

+ Add another row

Evidence Base

Ensure that the information in this section provides clear evidence of the information provided in the summary pages of this form (recommended maximum of 30 pages). Complete the **Annual profile of monetised costs and benefits** (transition and recurring) below over the life of the preferred policy (use the spreadsheet attached if the period is longer than 10 years).

The spreadsheet also contains an emission changes table that you will need to fill in if your measure has an impact on greenhouse gas emissions.

Annual profile of monetised costs and benefits* - (£m) constant prices

	Y ₀	Y ₁	Y ₂	Y ₃	Y ₄	Y ₅	Y ₆	Y ₇	Y ₈	Y ₉
Transition costs	0.07									
Annual recurring cost										
Total annual costs										
Transition benefits										
Annual recurring benefits**	0.009	0.009	0.009	0.009	0.009	0.009	0.009	0.009	0.009	0.009
Total annual benefits										

* For non-monetised benefits please see summary pages and main evidence base section

** Equivalent annual benefits



Microsoft Office
Excel Worksheet

Evidence Base (for summary sheets)

1. The proposal is to put in place a Special Administration Regime (SAR) for energy supply companies. It is intended that special administration would apply only to holders of gas and electricity supply licences. A SAR would allow the Government to fund a failing energy supply company's activities until it was either rescued, sold as a going concern or its customers transferred to other companies. The intention is that the funding would be recovered from the company if it were rescued, or the proceeds from its sale, if it were sold. If the company were not in a position to repay some or all of the loans or there were insufficient proceeds from the sale to cover the cost of special administration, there will be provision to allow the Secretary of State (SoS), with the consent of HM Treasury, to modify electricity and gas licences, subject to consultation with the industry, to recover any shortfall. We envisage that the SoS will exercise this power in relation to National Grid's licence and that any shortfall will be recovered through National Grid's network charges to industry participants. A SAR would ensure continuity of supply to customers at a more reasonable cost by allowing the failing company to continue to contract to supply gas and/or electricity to customers through its purchasing energy through normal contracts, as opposed to supplying customers through balancing and settlement arrangements. It would reduce the risk of contagion and maintain market stability and consumer confidence. An explanation of the industry balancing and settlement arrangements can be found at Annex 2.
2. The proposal for a SAR is intended to supplement the existing arrangements for dealing with the failure of a supplier. The most likely and desirable outcome, if a supplier were to become financially distressed or insolvent, would be a trade sale. If this were not possible, Ofgem would consider whether it would be practicable to appoint a Supplier of Last Resort. Only if these two options were not viable would the Government seek an energy supply company administration order, referred to in the rest of this document as a special administration order. It is likely that in most cases Ofgem would be able to appoint a Supplier of Last Resort and that special administration would be needed only in the event of a large supplier becoming insolvent.
3. This section will firstly examine the problem and the rationale for intervention and then examine the costs and benefits associated with the options considered.

The problem under consideration

4. Current arrangements to deal with the financial distress or insolvency of a gas and electricity supply company allow Ofgem to revoke the supplier's licence and appoint another supplier (a Supplier of Last Resort, or SoLR) to take over its customer accounts. This process usually takes between 24 and 48 hours. The arrangements have been tested several times over the last couple of years when small suppliers have failed. Although they have worked well, experience has shown that it is unlikely that they would be effective in the event of a large supplier becoming insolvent. There are two main reasons for this:
 - 1) For a supplier to take on the customers of one of the six largest supply companies may mean doubling the size of their customer base.
 - 2) A transfer of this size could not take place in an orderly manner in a short timescale. Ofgem can direct a supplier to be a Supplier of Last Resort only if that would not prejudice its ability to supply its existing customers. Ofgem may therefore be in a position where it cannot appoint a Supplier of Last Resort.
5. In addition, if it were practicable for a company to be appointed a Supplier of Last Resort any transfer of a large supplier's customers to another large supplier may be subject to agreement from the competition authorities, which could take several months.
6. Dividing up a company's portfolio of customers and transferring them to more than one supplier would be a difficult and time consuming task. It may be possible to transfer all gas customers to one supplier and all the electricity customers to another, relatively quickly, if other suppliers have the capacity to take on that volume of customers. This would depend on whether they could raise the necessary finance and put in place the necessary contracts. Once a supplier agrees to become a Supplier of Last Resort they are then responsible for the balancing and settlement charges whether or not the customers have been transferred to their systems. However, splitting the portfolio between two existing large suppliers could also give rise to concerns around competition.

7. Dividing the customer portfolio further would need to be done through the usual customer registration process when a customer switches supplier. This process currently deals with 3.6 million gas and 4.6 million electricity account switches each year and is designed to cope with a maximum of 20,000 electricity customers and 50,000 gas customers changing supplier each day. If a large supplier became insolvent then the system would have to cope with between 5m and 16m customer account transfers.

Rationale for intervention

8. In the very unlikely event of the failure of a large energy supplier, it is unlikely that it would be practicable to appoint a Supplier or Suppliers of Last Resort. However, the company's customers would still continue to be supplied even if the supplier's contracts with generators and gas suppliers had been cancelled, as National Grid would continue to balance the system. This would create additional costs in the short term and large unpredictable transfers of costs from the failed company to other industry participants in the medium to long run. This would put a considerable strain on the system, risking contagion and reducing consumer and market confidence.
9. A SAR would allow the Government to fund the company, so it could continue to supply customers through normal contracting arrangements with generators and gas suppliers. It should therefore diminish the overall uncertainty and risk, and reduce the risk of contagion. A SAR is essentially an insurance policy in case of a low probability, high impact event that could potentially destabilise the GB energy market.

The policy objective

10. The policy objective is to put in place arrangements to ensure that if a large energy supplier became insolvent :
 - its customers would continue to be supplied as cost effectively as possible
 - any impact on the industry systems, particularly balancing and settlement, arising from large, unpredictable transfers of costs from a failed supplier to other industry participants, are minimised;
 - market stability and customer confidence would be maintained.
11. A SAR would achieve these objectives by providing a mechanism through which the Government could fund a failing company's activities until it is either rescued, sold as a going concern or its customers transferred to two or more companies. The intention is to recover the Government funding from the insolvent company if it were rescued or from the proceeds of its sale if it were sold. If all or part of the funding could not be recovered from the company or the proceeds of its sale the intention is to recover it through network charges.

Options considered

12. Three options have been considered:
 - 1) Do nothing
 - 2) Industry system and code changes
 - 3) Legislate for a SAR (preferred option)
13. In the event of a large supplier failure, these options would have different results. It should be noted that in the event of a small supplier failing it is assumed that existing industry mechanisms would be enforced ie – a small supplier may be sold through a trade sale or if that were not possible, Ofgem would revoke its licence and appoint a Supplier of Last Resort. These options are explained in detail below:

1) Do nothing

14. Under the current regime, a failing supplier would be subject to ordinary insolvency procedures.

If the company entered into administration, we assume that all or some of its purchasing contracts would be cancelled. In the supplier insolvencies that have occurred so far and that have resulted in the Supplier of Last Resort process being invoked, purchasing contracts have been cancelled. This was also the case when a large non physical trader (ie a company that buys and sells energy on the energy exchange) went into administration. Companies that had contracts agreed with the trader began pull out rapidly. Therefore we have assumed that all or some of the failing company's contracts would be cancelled.

15. If the administrator agreed to pay the balancing and settlement costs, Ofgem would not revoke its supply licence. Whether or not the administrator could secure finance would depend on whether existing creditors believed they had a better chance of recovering some or all of their investment by extending the loans.
16. Assuming the administrator is not in a position to pay the balancing charges, Ofgem would then seek to appoint a Supplier of Last Resort or Suppliers of Last Resort to take on the customers of the failed supplier. A conservative estimate suggests the customer bases of the six largest suppliers range from 3.3 million customers for the smallest to 9.8 million customers for the largest. Given the large number of customer accounts involved this would not take place quickly.
17. For a smooth transfer of customers from one supplier to another, the Market Participant ID (for electricity) and the Shipper Short Code (for gas) needs to be transferred from one supplier to another. This allows all the gas customers to be transferred in bulk to another supplier and all the electricity customers to be transferred in bulk. If no suppliers are in a position to take on all of a company's gas customers or its electricity customers, then the customers would have to be transferred to up to five companies. These transfers would have to take place via the change of supplier process. This process generally handles 3.6 million gas and 4.6 million electricity account transfers a year and is designed to allow up to 20,000 electricity customers and 50,000 gas customers to transfer each day. During this time the company's customers would continue to be supplied through the balancing mechanisms at a large cost to other market participants. As demonstrated later this would place a significant strain on the system with a serious risk of contagion effects.
18. As mentioned above it may be feasible under the Supplier of Last Resort Process to transfer quickly all gas customers to one supplier and all electricity customers to another, if two other suppliers are in a position to take on a large volume of additional customers at short notice. However, we believe there would be a significant impact on competition, which is likely to require a 45-day merger investigation by the OFT. This is likely to result in a further referral to the Competition Commission. A Competition Commission inquiry would take 6 months.
19. In addition, if Ofgem were unable to appoint a Supplier of Last Resort, under ordinary administration law if an administrator believed the losses incurred through continued trading were spiralling out of control, he/she could seek to liquidate the company and disclaim the contracts it had with customers if they were considered onerous. This would leave customers being supplied, but not being billed as they would no longer have a contract with a supplier. As the balancing and settlement arrangements require that unpaid balancing charges are smeared across parties to the balancing and settlement codes, these costs would ultimately be borne by other consumers.
20. As discussed earlier, we believe it is unlikely that Ofgem would be able to appoint a Supplier or Suppliers of Last Resort under these circumstances.

2) Industry systems and code changes

21. We considered whether the issue of the large and unpredictable transfer costs that would arise if a supplier became insolvent could be addressed by systems or code changes that rely on industry governance arrangements rather than primary legislation. For instance, we considered whether it would be feasible to increase the credit cover that industry participants are already required to post as signatories to, for example, the Balancing and Settlement Code (the code governing the

balancing and settlement arrangements for electricity) and the Uniform Network Code (the code governing the balancing and settlement arrangements for gas).

22. The current industry credit cover arrangements are intended to protect industry participants if another participant defaults on their imbalance charges. For example, in the case of the Balancing and Settlement Code, an initial settlement payment is due 29 days after the settlement date and current arrangements require participants to post sufficient credit to cover the 29 days of expected imbalance charges. An option would be the introduction of some form of insurance pool or additional credit cover, to which industry participants contributed. In the event of a large supplier failing, these arrangements would provide funds to cover the costs that would otherwise be smeared across other industry parties until the market stabilised.
23. However, these options were not explored in detail as it was clear from the outset that they would result in up-front costs being incurred by industry participants and in any case could not be relied upon to provide sufficient funding in all circumstances. In the event of a large supplier failing, neither option would be expected to have a net effect on the level of transfers of costs from the failing supplier to other industry participants: the effect of introducing some form of insurance pool or additional credit cover would be to effectively bring a proportion of the transfer of costs forward in time, as well as adding some additional reporting and verification burdens on industry and Ofgem.

3) Legislate for a special administration regime (preferred option)

24. Our preferred option is to legislate for a SAR. This is our preferred option because a SAR would allow an insolvent company to continue to supply customers as cost effectively as possible, reduce the impact of large unpredictable transfer costs, and offer the least disruption to gas and electricity market arrangements.
25. If a SAR were in place, should a company fail and in the event that Ofgem advised it is unable to appoint a Supplier of Last Resort, the SoS would apply to the court for a special administration order. The special administrator's primary objective would be to maintain supply to customers as cost effectively as is reasonably practicable in the circumstances. It would therefore not be necessary to use the balancing mechanism outside usual use, because the administrator would be able to enter into new contracts to purchase energy. The court would grant the special administration order subject to the company meeting the statutory tests for insolvency.
26. In this situation the Government would be able to provide grants or loans, as well as underwriting any loans taken out by the special administrator in order to maintain electricity and gas supply. The SoS would be able to stipulate when the loans are repaid and the rate of interest.

Costs and benefits

27. This section will examine the costs and benefits of a SAR compared to the current arrangements.

❖ Benefits of SAR

28. The main benefits of a SAR will only be realised in the event of a large supplier insolvency, however these are potentially large. The benefits will come from three main sources: a lower short run cost of balancing compared to the current regime, reduced impact of transfers from the insolvent supplier to other industry participants and limited contagion effects compared to the current regime. In order to examine the overall net benefit of a SAR in the event of a large supplier insolvency we also examined the additional costs of a SAR in the event of an insolvency to estimate the overall probability-weighted net benefit. These are discussed below:

1. Lower Short Run Balancing Costs

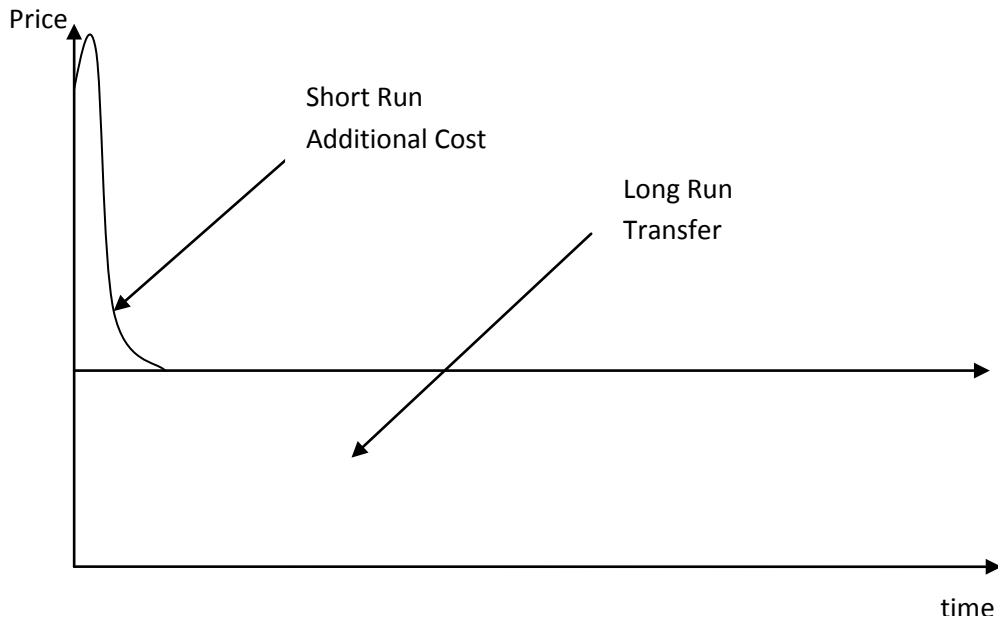
29. Under the current arrangements, if a large supplier were to go into administration, some or all of their contracts would be cancelled. As the customers would continue to draw electricity and gas from

the respective networks we would expect National Grid to use the balancing mechanisms to supply customers. We would expect this to have minimal additional effect on the gas network. However, as electricity cannot be stored and is balanced at half-hourly intervals we would expect balancing prices to rise in the very short term. We would then expect prices to fall quickly as spare generation (as a result of the cancelled contracts) becomes available. However, there is a risk that generators may increase their prices at a time of market uncertainty. It is also important to note that imbalance charges can be volatile and can rise and fall depending on conditions affecting demand and supply in the wholesale gas and electricity markets and the actions of other market participants.

30. This effect is demonstrated in a recent example of when a small electricity supplier became insolvent. This company of 40,000 customers accrued around £4.9m in balancing charges for approximately 172GWh, during the period between its going into administration and another supplier taking over the customers – a period of less than 48 hours. We would not necessarily expect these costs to be replicated on a larger scale if one of the big six suppliers became insolvent. The cost would depend on:
- the number of customers supplied;
 - volume of gas and electricity supplied;
 - the time of year;
 - prevailing weather;
 - availability of power;
 - the extent to which the company generates its own electricity and trades in gas;
 - the extent to which its generating and trading arms would continue to supply the supply arm.
31. Conservative estimates suggest the customer bases of the six largest electricity and gas suppliers range from 3.3 million customers for the smallest to 9.8 million customers for the largest, these figures do not include dual fuel customers. Of these companies, one has the capacity to generate sufficient electricity to supply all its customers. The other five have the capacity to generate between 87% and 40% of the electricity they supply. None of these companies maximise self-supply and in the event of an insolvency there is no guarantee that the generation arm would continue to supply the supply company if it were not honouring its contracts. For this impact assessment we have assumed companies do not self-supply in the event of insolvency.
32. We have assumed that the balancing costs would remain high for a period of up to 24 hours, before falling to market prices as generators attempt to sell their electricity. However, it is difficult to predict how generators would react and it may take longer for prices to settle. We have used an approximation of average daily demand figures to estimate the daily cost of providing electricity through the balancing mechanism for an average sized large supplier. Using the average System Buy Price for a three month period over winter 08/09² (when prices were high) we expect the cost of balancing for a 24 hour period would average £12.1m. This would be at a £1.5m additional premium (see diagram) over the usual market price (using day-ahead prices for the same time period). This figure is an average, it could be larger or smaller depending on the size of company and energy prices. Furthermore imbalance charges can be volatile and can rise and fall depending on conditions affecting demand and supply in the wholesale gas and electricity markets and the actions of other market participants.
33. There may also be an additional risk premium charged by the market in the event of the insolvency of a large supplier in the short and possibly medium-term. We have not been able to estimate the size of this effect.
34. This additional cost would not occur if a large supplier became insolvent with a SAR in place as the company would not require use of the balancing mechanism above usual operations and therefore is a net benefit of a SAR (see Figure 1).

² For this impact assessment we have assumed that the insolvency has occurred in a winter as the system is more likely to be under strain at this time, and it has been suggested that an insolvency is more likely to occur at times of system stress. In order to provide reference prices we have chosen a winter when prices were relatively high, ie Winter 08/09, as we believe this better simulates a situation when the system is under some level of stress.

Figure 1: Cost of supplying energy in the event of an insolvency



2. Reducing the impact of transfers of costs from the insolvent supplier to other industry participants

35. Under both ordinary administration (and in the event of the administrator not being able to secure private finance enabling it to purchase energy supplies) and a SAR (and in the event of the special administrator not being in a position to repay some or all of the loans made by Government), there would be transfers of costs between the insolvent supplier and other industry participants. However, a SAR would reduce the impact of transfers between the insolvent supplier and other industry participants, through:
- a reduction in the level of transfers, by reducing the costs of supplying customers with electricity (see section above); and
 - greater predictability of the flow of transfers.
36. In the following paragraphs, we explain this in more detail.
37. Under the current arrangements, should a large energy supplier become insolvent, and should the administrator be unable to secure finance to purchase energy supplies, the cost of providing electricity and gas to customers of the insolvent company would be met by other industry participants. The liability for supplying customers of the insolvent company is transferred from the insolvent supplier to other industry participants, and ultimately customers of other suppliers.
38. Under a SAR, the Government is able to provide grants or loans (or to underwrite any loans taken out by the special administrator in order to maintain electricity and gas supply). Should the company not be in a position to repay some or all of the loans, there will be provision to allow the SoS to modify electricity and gas licences, subject to consultation with the industry, to recover any shortfall. We envisage that SoS will exercise this power in relation to National Grid's licence and that any shortfall will be recovered through National Grid's network charges to industry participants. As under the current arrangements (see paragraph above), these costs would ultimately be borne by customers of other suppliers. However, the value of transfers would be lower, relative to ordinary administration, as a SAR would allow the failing company to continue to contract to supply gas and/or electricity to customers through the usual purchasing contract mechanism, as opposed to supplying customers through balancing and settlement arrangements. The transfers under a SAR would thus be lower, to the extent that:

- short-run balancing costs are avoided under a SAR; and
 - under ordinary administration, there is likely to be an additional risk premium charged by generators.
39. Under a SAR, transfers would also be predictable as the full extent of any shortfall could be recovered gradually, placing less strain on industry participants. To help demonstrate the importance of this issue, we provide an illustration below of the scale of the absolute value of transfers.
40. We have used daily demand of an average large supplier to estimate the ongoing daily cost of supplying electricity and gas to consumers at market prices. In the event of the failure of a large supplier, we have assumed the balancing markets would be used to purchase all electricity and gas for that supplier's customers. Balancing prices would therefore quickly (we are estimating within 24 hours) become similar or equivalent to spot prices. Using the average day-ahead price from three months in winter 08/09, we have estimated that the daily cost of providing energy (electricity and gas) to customers could be around £19.6m per day for an average large energy supplier. The actual figure could be smaller or larger depending on the size of the company and the price of energy. This would first of all be recovered from the security held with each of the balancing services, however then costs would be passed through to the parties to the balancing and settlement codes (for electricity - generators, suppliers and non physical traders, for gas – shippers and non physical traders).
41. As these costs would have normally been paid by the insolvent supply company (who we assume is still billing customers) these costs are not additional. However, they do represent a significant unpredictable transfer in liability from the creditors of the insolvent company to other industry participants.
42. We are unable to estimate how long a company may be in administration, and therefore the combined size of these transfers. Under ordinary administration rules a company may remain in administration for up to a year, however we would expect the true period to be shorter, as special administration would cease once all customers were transferred to other suppliers. To illustrate the potential size, if an average large supplier were in administration for a 3 month period during the winter, the cost of providing energy over that time would be approximately £1.8bn. This would represent the size of the transfer from the insolvent company to other market participants who would be required to pay for the energy supplied to customers of the insolvent company for the length of the administration. For a 6 month administration the total transfers would be approximately £2.3bn (this figure assumes that for the second three months, the price of energy is lower due to seasonal changes). The transfers could be greater depending on how long the company were in special administration, the size of the company's customer base and the price of energy.
43. These transfers could potentially be much larger once distribution and transmission charges are taken into account. Distribution companies can recover bad debt through their charges to suppliers. They must receive Ofgem consent to initiate this recovery process. We have assumed that Ofgem would give consent. In the case of the recent small supplier that became insolvent, the company ended up owing electricity distribution charges of £2.5m which represented 34% of the total charges accrued during the 48 hours period before a Supplier of Last Resort was appointed. To estimate the cost on a distributor we have applied the same percentage to the cost transfers. For a 3-month administration the transfer from creditors of the insolvent company to distribution companies could be £612m, and for a 6-month administration the transfers could total £782m. Please note, these figures are illustrative as we are unsure how the cost would vary for gas distributors and have used the electricity distribution as an approximation.

3. Contagion Effects

44. The third benefit of a SAR is that it will limit contagion effects in the event of insolvency. As described above, in the event of a large supplier insolvency there will be large unexpected cost transfers from the insolvent company to other market participants. This will cause cash flow

problems for other market participants, putting a strain on the system and threatening the stability of other market participants.

45. An insolvency of a large supplier may destabilise the market, with potential contagion risks. We have been unable to estimate the potential size of these effects. However, we expect them to be large.
46. Under a SAR, there would be limited and orderly transfers and therefore the contagion risks would be minimal. This is a net benefit of SAR.

4. *Probability Weighted Net Benefit*

47. In order to examine the overall net benefit of a SAR in the event of a large supplier insolvency we need to examine what potential cost saving a SAR offers compared to the current regime. This allows us to estimate the overall probability-weighted net benefit.
48. If a SAR were in place the SoS would apply to the court for a special administration order. The objective of the special administrator would be to maintain supply to customers as cost effectively as is reasonably practicable in the circumstances. The special administrator would also be required to act in the best interests of creditors and shareholders in so far as it is compatible with the duty to maintain supply.
49. The Government would face the administrative cost of applying to the court for a special administration order and the administrative costs of setting up and recovering the loans. The SoS would be able to stipulate when the loans are repaid and the rate of interest. We assume that the rate of interest would be set in order to recover the administrative costs to Government of setting up the loans. If the company were not in a position to repay some or all of the loans, there will be provision to allow the SoS to modify electricity and gas licences, subject to consultation with the industry, to recover any shortfall. We envisage that SoS will exercise this power in relation to National Grid's licence and that any shortfall will be recovered through National Grid's network charges to industry participants. We assume therefore that the cost of the loan to the state would be zero. However, there may be some additional costs to government and Ofgem associated with time and resources taken to negotiate with the special administrator and put in place loans quickly. If any of the loan were recovered through network charges there would also be administrative costs to National Grid in recovering the costs and passing them back to Government. We have been unable to estimate the size of these administrative costs.
50. The cost of an administrator would be paid out of the funds realised throughout the process. A special administrator would operate along similar lines to an ordinary administrator and therefore it is assumed that there would be no difference in costs associated with the expenses of a special administrator to those incurred by an ordinary administrator.
51. In order to estimate the true net benefit of these measures we need to account for the probability of a large energy supplier becoming insolvent. Using evidence from rating agencies and historical default histories of companies with similar ratings, we estimate that the probability of a large energy supplier becoming insolvent ranges from 0.01% and 0.08% per year. Over a 20 year period, the probability of a large supplier failing in any year is between 0.2% and 1.6%. However, the risk of needing to apply for a special administration order would be even smaller as the most likely outcome of a supplier insolvency would be a trade sale and if this were not achieved, it may be possible in certain circumstances for Ofgem to appoint a Supplier of Last Resort.
52. The net benefit of these measures would range between £0 and £247k depending on the probability of default for an averaged large supplier, the figures would vary depending on the demands of the insolvent company and the price of energy. This figure includes only the additional benefits (due to not using the balancing system). The figure does not include the possible benefits due to limited contagion effects which we would expect to be large. To illustrate this, we might assume that the contagion effects were equal to the transfer payments for energy provided. For a three-month administration (which we believe would be a conservative estimate due to the complexity of the

situation), this would give a probability weighted net benefit of between £3.6m and £387m, and for a six month administration the probability weighted net benefit could be between £4.6m and £370m.

❖ *Costs of Introducing a SAR*

53. Having illustrated how a SAR could potentially be cost-saving in the event of a large supplier insolvency, we must now examine the costs of introducing a SAR. It should be noted that the proposals are to introduce enabling powers which will enable Government to put in place a SAR. As such costs have only been covered at a high level. There are predominantly two types of cost: direct costs include the costs of putting the regime in place and indirect costs include the effect of the policy on the cost of capital. These are examined below:

1. The Direct Costs of Setting Up a SAR

54. The costs of setting up a regime will primarily fall on Government and Ofgem, in the form of officials' and parliamentary counsel's time in defining and drafting the enabling powers required to set up the regime and the rules to implement the regime. We have estimated these to be £70k. There may also be some small administrative costs associated with any consequential amendments to the industry's balancing and settlement codes as these are currently designed around the current arrangements that assume the appointment of a Supplier of Last Resort.

2. The Indirect Costs on Capital

55. Investors' response to SARs tend to vary according to the sector in question, how the companies are financed and the company's credit rating. Investors' reaction to the introduction of a SAR in a sector where companies are financed against long term debt and are highly leveraged is more likely to increase the cost of capital. Our investigations have shown that this is not the case in the energy supply sector, where companies tend to be financed via short term loans against business plans. Feedback from energy companies has confirmed that it is unlikely that the introduction of a SAR for suppliers will increase the cost of capital.
56. In addition a prudent investor would already have considered government intervention to maintain security of supply as a strong possibility and will have already discounted this risk. There is no evidence that the SAR for gas and electricity network and distribution companies has resulted in an increase in the cost of capital.

3. Indirect Costs - Moral hazard Issues

57. It could be argued that the regime will encourage excessive risk taking. However, this will be mitigated by the fact that the Supplier of Last Resort process could still be invoked during special administration with the result that the special administration could be terminated by a transfer of customers to other companies for which the failing company will receive no payment. The first objective of the special administrator would be to rescue the company, then to sell it as going to concern and then to transfer the activities and assets to other companies. If the special administrator were unable to meet these objectives then the Supplier of Last Resort process would come back into play.
58. It could also be argued that if a company were in difficulty its directors may be tempted to accelerate its failure knowing that it will be underwritten by the Government. However, the secondary legislation that will follow the primary legislation will allow for investigations into the conduct of directors in the same way as the ordinary administration rules do.

❖ *Summary of Costs and Benefits*

59. The principal costs associated with this proposal are the costs of putting in place the regime, which is borne by Government and Ofgem.

60. The net benefit of these measures would range between £0 and £247k. This figure only includes the additional benefits (due to not using the balancing system) and is weighted to account for the probability of a large supplier becoming insolvent in the next 20 years. The figure does not include the possible benefits due to limited contagion effects, which we would expect to be large. The benefits could be considerably larger depending on the length of time that the company is in special administration, the price of energy and the size and energy demands of the insolvent company's customer base.

Risks and assumptions

61. The risks and assumptions are discussed in the 'costs and benefits' section. We have had to make several assumptions in order to estimate the net benefit of these measures. The estimates reflect the price of providing energy to the customers of an average large energy supplier. The figures would vary depending on the actual size of the supplier and its customer base, the price of energy at the time of the insolvency, the extent to which the company self-supplies, the market reaction and any potential risk premium and the length of time the company was in administration
62. The main risk of the proposed option is that it will have an effect on the cost of capital. However, as discussed above, we believe that this will be minimal.

Administrative burden and policy savings calculations

63. This proposal imposes one small additional administrative cost on energy supply companies should they become insolvent. The legislation will require that the businesses notify the Secretary of State and Ofgem if they are seeking to place the company into ordinary administration or wind it up. This notification requirement will also apply to floating charge holders and creditors that apply to the court for an ordinary administration order.

Wider Impacts

64. We do not believe these measures will require any specific impact tests

Summary and preferred options with description of implementation plan

65. The preferred option is to introduce a SAR for electricity and gas suppliers.

Annexes

Annex 1 should be used to set out the Post Implementation Review Plan as detailed below. Further annexes may be added to provide further information about non-monetary costs and benefits from Specific Impact Tests, if relevant to an overall understanding of policy options.

Annex 1: Post Implementation Review (PIR) Plan

A PIR should be undertaken, usually three to five years after implementation of the policy, but exceptionally a longer period may be more appropriate. A PIR should examine the extent to which the implemented regulations have achieved their objectives, assess their costs and benefits and identify whether they are having any unintended consequences. Please set out the PIR Plan as detailed below. If there is no plan to do a PIR please provide reasons below.

<p>Basis of the review: [The basis of the review could be statutory (forming part of the legislation), it could be to review existing policy or there could be a political commitment to review];</p>
<p>Review objective: [Is it intended as a proportionate check that regulation is operating as expected to tackle the problem of concern?; or as a wider exploration of the policy approach taken?; or as a link from policy objective to outcome?]</p>
<p>Review approach and rationale: [e.g. describe here the review approach (in-depth evaluation, scope review of monitoring data, scan of stakeholder views, etc.) and the rationale that made choosing such an approach]</p>
<p>Baseline: [The current (baseline) position against which the change introduced by the legislation can be measured]</p>
<p>Success criteria: [Criteria showing achievement of the policy objectives as set out in the final impact assessment; criteria for modifying or replacing the policy if it does not achieve its objectives]</p>
<p>Monitoring information arrangements: [Provide further details of the planned/existing arrangements in place that will allow a systematic collection of monitoring information for future policy review]</p>
<p>Reasons for not planning a PIR: [If there is no plan to do a PIR please provide reasons here]</p> <p>There are no current plans to review the policy as it is a contingency measure and the probability that it will be called upon is low. However, if it ever were called upon, we would evaluate and review its effectiveness.</p>

Annex 2 Balancing and settlement

66. The arrangements by which the electricity industry manages electricity balancing and settlement are governed by a Code (The Balancing and Settlement Code or BSC). Suppliers are obliged by a licence condition to be a party to the code and comply with it. The energy balancing aspect allows parties to make submissions to National Grid to either buy or sell electricity into/out of the market in order to keep the system balance. The settlement aspect relates to monitoring and metering the actual positions of generators and suppliers (and interconnectors) against their contracted positions and settling imbalances when actual delivery or offtake does not match contractual positions.
67. Supply must always match demand as electricity cannot be stored. Although the generation, transportation, delivery and usage of electricity is continuous, for the purposes of trading and settlement electricity is considered to be generated, transported, delivered and used in half-hour chunks called Settlement Periods. For each half-hour, those with demand for electricity and/or those with customers with demand for electricity (e.g. Suppliers) will assess in advance what the demand will be. They will then contract with generator(s) for that volume of electricity. Contracts can be struck up to an hour before the Settlement Period which the contract is for (this cut-off is known as Gate Closure and contracts can't be notified after this time). In the half hour itself, generators are expected to generate and deliver their contracted volume of electricity and suppliers are expected to use their contracted volume of electricity. Afterwards, metered volumes are collected for the half hour from generators and suppliers, and compared against their contracted volumes. If a supplier has used more electricity than they contract for, they must buy more electricity from the grid to meet the amount used. If they haven't used all their contracted energy then they must sell the energy back to the grid. These prices reflect the balancing actions National Grid have had to take and are designed to incentivise suppliers and generators to balance. The 'buy' price will usually be more expensive than the market price of electricity; and the sell price will normally be below market price.
68. These differences are referred to as imbalances, and settlement is the process of calculating the volumes of imbalance and the prices to be paid for these imbalances. As more accurate data comes into Settlement, Elexon, the company responsible for running the balancing and settlement mechanism, repeats the calculations on four occasions, spaced across 14 months for each half-hour period, providing a more accurate picture of Settlement each time. If a company is unable to pay its settlement costs, this cost is borne by all the parties to the code in proportion to their contracted volumes.
69. If a supplier goes into administration it is likely that its energy purchasing contracts will have been cancelled. However, electricity would continue to flow to customers. The company would be obliged by the BSC to purchase electricity through the balancing mechanism. The company does not contract to buy electricity, but is given a bill after Elexon have carried out their imbalance calculations, which show the discrepancies between what companies forecast they would supply and what they actually supplied. In the case of an insolvent supplier all of whose purchasing contracts have been cancelled, this would be all the electricity used by their portfolio of customers they since their contracts had been cancelled. As the system is designed to incentivise suppliers and generators to forecast their generation and supply needs as accurately as possible, the cost of buying electricity through balancing is usually considerably higher than "normal" contract prices. Usually around 3% of electricity is purchased through balancing and it is generally used to make up unanticipated additional demand. Where a settlement bill is unpaid, Elexon will ultimately smear those charges across other participants to the Balancing and Settlement Code.

70. As gas can be stored, demand and supply does not have to be balanced on a second by second basis. Gas supply and demand is balanced over a 24 hour period. Shippers are responsible for balancing demand and supply and are therefore signatories to the Uniform Network Code. It is shippers, not suppliers, that incur financial penalties if they do not buy and sell the gas for which they have contracted. Suppliers are not party to Uniform Network Code. However, in many cases (and certainly in the case of large suppliers), the Shipper and the Supplier are the same company and hold both licences. There is a requirement in the gas Supply licence for establishing an agreement that if a Shipper is unable to pay its debts, then the Supplier is responsible for payment.