Continuity of essential supplies to insolvent businesses

Department for Business, Innovation and Skills (Insolvency Service)

RPC rating: validated

Description of proposal

The measure prevents the use of termination clauses or charging of 'ransom' payments for 'essential supplies' to insolvent businesses. For the purposes of the proposal, essential supplies are defined as utilities and IT services. These are usually central factors in enabling successful business rescue and can be difficult to secure from alternative providers.

Termination clauses enable suppliers to withdraw services automatically when a business becomes insolvent. Ransom payments refer to the practice of charging additional payments, or requiring early payment of outstanding debts, as a condition of ongoing supply. Both practices reduce the chance of, and the funds available to support, a successful rescue. This can unfairly reduce the payments made to other creditors. Intermediary providers ('on-sellers') of essential supplies will also be prevented from using termination clauses or ransom payments.

Impacts of proposal

Benefits

The Department uses evidence from surveys of insolvency practitioners to estimate that around 960 liquidations (7% of the average 13,700 liquidations) each year could be avoided if essential supplies were maintained. The Department compares the rate of return for unsecured investors in the event of liquidation (negligible/virtually zero) and administration (4% on average, not requiring the business to be rescued). Using Companies House data, the Department estimates that the average amount due to unsecured creditors of insolvent businesses in administration is £1.2 million. This figure is used by the Department to estimate that on average each use of administration rather than liquidation delivers a benefit to unsecured creditors of around £48,000. On this basis the Department expects the proposal to result in a total benefit to creditors of £46 million each year. Based on Companies House data and an Office of Fair Trading study, businesses are estimated to account for 90% of creditors, leading to an estimated benefit to business of £41.4 million each year.

Costs

Businesses that provide essential supplies to insolvent businesses will face increased on-going costs as a result of the ban on termination clauses and ransom payments, and one-off familiarisation costs.

The use of termination clauses enables suppliers to switch insolvent businesses to higher cost short term contracts that reflect the increased risk of bad debt, and the potential need to purchase gas and electricity on short term markets. Banning the use of these clauses will transfer the risk and associated costs to suppliers. This is estimated to increase their costs by £16.8 million each year. As the benefits of this transfer will be to insolvent businesses' unsecured creditors, of which 90% of returns are to business, 10% of the transfer is expected to accrue as a benefit to non-businesses. As such, the ban on the use of termination clauses is expected to result in a net cost to business of £1.68 million each year (10% of the total transfer).

The ban on ransom payments is expected to result in a similar transfer between insolvent businesses and suppliers, with the most significant effect being on IT suppliers. The Department uses estimates for the proportion of insolvent businesses that continue trading, based on volumes of the procedures most likely to result in business rescue (company voluntary agreements and administration), to estimate around 500 insolvent businesses continuing to trade each year. The businesses that continue to trade will potentially be subject to ransom payments. In 55% of cases of insolvency IT suppliers require ransom payments, and in 25% of cases for utility services. The median ransom payment for IT suppliers is £5,000, and £500 for utility services. Banning ransom payments is expected to result in a transfer from suppliers to unsecured creditors of £1.47 million each year, with 10% of this being a benefit to non-business customers (a net cost to business of £0.15 million each year).

The Department estimates that around 2,070 suppliers will need to familiarise themselves with the proposals. This is based on the estimates of the number of companies that currently use termination clauses or require ransom payments. This is expected to impose one-off costs on business of £51,000, based on one hour of a financial manger's time per supplier.

Net impact

The RPC is able to validate the estimated equivalent annual net cost to business (EANCB) of -£38.3 million.

Quality of submission

The RPC previously issued a fit for purpose opinion on the proposal. Subsequent to that opinion, the government has amended the better regulation framework so that beneficial new regulation will count towards the government's business impact target. As the proposal was considered a 'zero net cost' measure under the previous framework, the Department has now sought confirmation of the estimated EANCB as a net benefit to business.

The IA sets out clearly the expected impacts of the measure, and provides sufficient supporting evidence in relation to the assumptions used. A key assumption used to support the scale of the benefits is the number of liquidations that the proposal is expected to avoid. The Department refers to two surveys of insolvency practitioners that suggest that either 7% or 14% of liquidations could be avoided if essential supplies were maintained. The Department have used the 7% estimate as this is based on the most recent survey. This approach appears to provide the best estimate of the proportion of businesses likely to be rescued from insolvency.

Small and micro business assessment

The measure is regulatory with gross costs over £1 million in the most expensive year and, therefore, a small and micro business assessment is required. The Department has provided a very detailed analysis of the impacts of the proposal on smaller businesses, including providing a detailed assessment of the potential costs to small and micro businesses as unsecured creditors if there were to be exemptions for small businesses as suppliers. The IA also discusses the extent to which smaller businesses are likely to benefit from improved chances of a successful rescue. As an exemption for small suppliers would result in a transfer between small businesses (compared to the preferred option) while reducing the overall net benefit of the proposal, an exemption for small suppliers would result in a lower net benefit overall and for small businesses.

The assessment of the impacts on smaller businesses highlights that while there will be some smaller businesses in the sectors that face increased costs as a result of the restrictions on activities (such as ransom payments), the proportion of businesses that would be considered small or micro in those sectors is lower than in the general business population. As businesses entering insolvency are more likely to be small and micro the transfer from suppliers to insolvent businesses is expected to deliver a net transfer to small and micro businesses from larger businesses.

Departmental assessment

Classification	Qualifying regulatory provision

	(Beneficial new regulation)
Equivalent annual net cost to business (EANCB)	-£38.3 million
Business net present value	£334.5 million
Societal net present value	£389.9 million

RPC assessment

Classification	Qualifying regulatory provision (beneficial new regulation)
EANCB – RPC validated[1]	-£38.3 million
Small and micro business assessment	Sufficient

Michael Gibbons CBE, Chairman

[1] For reporting purposes, the RPC validates EANCB figures to the nearest £100,000.