

June 2001

**Supplier of Last Resort – Security cover
and levies**

A Consultation document

Summary

This document explains the following:

- the requirement under the Utilities Act for domestic gas and electricity suppliers to provide security cover in line with principles set by the Authority;
- the circumstances in which a Supplier of Last Resort (SoLR) might be able to claim for its otherwise unrecoverable losses;
- the availability of a levy from transportation and/or distribution companies if the failed supplier's security cover is insufficient;
- the cost to the industry (and ultimately customers) of providing security cover; and
- the adverse effect on smaller suppliers of having to provide security cover and the potential effect on competition that this has.

Having considered the potential impact of all these issues on customers and on competition, Ofgem proposes that the level of the security cover in both gas and electricity should be set to zero at the point the Utilities Act standard licence conditions are introduced.

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1. Introduction

Purpose of this document

- 1.1 In March 2001 Ofgem published a document ("the Guidance Document"¹) that explains the steps that Ofgem is likely to take if a domestic gas or electricity supplier fails. It explained the circumstances under which Ofgem is likely to revoke a supplier's licence and the steps it would expect to take to appoint another supplier (the Supplier of Last Resort ("SoLR")) to take over the failed supplier's customers.
- 1.2 Domestic gas suppliers are currently obliged to maintain security cover² or other instrument to provide security cover³. This obligation will be extended to domestic electricity suppliers when the Utilities Act 2000 ("the Utilities Act") standard licence conditions come into force (currently expected to be in August)⁴. In some circumstances a SoLR may make a claim for its otherwise unrecoverable costs against the failed supplier's security cover. If the security cover is not sufficient it can also make a claim for its remaining costs from gas transporters or (under the Utilities Act) electricity distribution companies. The Guidance Document explained that Ofgem would, in the first instance, seek to appoint a SoLR that has agreed in advance not to make any claim. The Guidance Document did not discuss detailed consideration of the principles for setting the security cover under the Utilities Act. That is the purpose of this consultation document.

Rationale

- 1.3 The Utilities Act standard licence condition 33 states that the value of the security cover must be calculated in accordance with principles determined by the Gas and Electricity Markets Authority ("the Authority") and notified to each licensee. The value is based on an amount for each domestic premises supplied and an amount

¹ "Supplier of last resort - Guidance on current arrangements", Ofgem, March 2001

² Section 3.4 of this document explains the different types of security that may be used at the moment.

³ Current Gas Supply Licence Standard Condition 9 – Security for payments where last resort directions are given

⁴ Utilities Act Standard Licence Condition ("SLC") 33 – Last Resort Supply: Security for Payments

per kWh of gas or electricity supplied to those premises. It cannot exceed a maximum specified in the licence⁵.

- 1.4 The Authority may at any time vary the principles for calculating the security cover following consultation with all suppliers and the Gas and Electricity Consumers' Council ("energywatch")⁶. When the domestic gas market was opened to competition starting in April 1996 the value of the security cover was set at £1 per domestic premises (multiplied by the number of premises expected to be supplied) plus £0.006 per therm (multiplied by the total quantity of gas expected to be supplied per year).
- 1.5 The principles on which the gas security cover was set have not been reviewed since the start of domestic competition. The introduction of new standard licence conditions presents an ideal opportunity for an informed and open consultation about the principles that the Authority should use when determining the value of the security cover.

Context

- 1.6 In October 2000 Ofgem consulted on final proposals for new standard licence conditions under the Utilities Act 2000. These included new standard conditions for gas and electricity supply licences. Amongst other things, the proposals included conditions relating to:
- the appointment of one or more electricity SoLRs to supply a failed supplier's customers;
 - a requirement on domestic electricity suppliers to have security cover (matching the equivalent obligations in gas suppliers' licences);
 - the extension of the provisions in gas to enable the appointment of one or more SoLR for all gas customers; and

⁵ SLC 33(5) and 33(13)

⁶ SLC 33(4)

- the ability for electricity distribution companies to increase their use of system charges following a claim by a SoLR (matching the equivalent ability for gas transporters).

1.7 The Department of Trade and Industry ("DTI") issued its proposed final drafts of the standard licence conditions on 26 March; responses to the consultation are being considered. The relevant conditions as they now stand are at Annex 1. It is for the Secretary of State to determine the standard conditions. However the DTI has indicated that the new standard licence conditions are expected to take effect from August 2001; new licensing schemes will be introduced at the same time. If the licence conditions relating to the issues covered in this document were to change substantially, Ofgem would consider whether a further consultation document should be issued.

Structure of this document

1.8 The rest of this document is structured in the following way:

Chapter 2 explains the legal and regulatory framework after the Utilities Act gas and electricity standard licence conditions come into force.

Chapter 3 explains the background to and principles used in setting the current security cover for gas suppliers. It explains the maximum level at which the security cover could be set under the Utilities Act.

Chapter 4 discusses the need for security cover.

Chapter 5 concludes that the security cover should be set at zero in both gas and electricity following the introduction of the Utilities Act standard licence conditions.

1.9 The timetable for subsequent events is as follows:

- Friday 13 July - deadline for comments on the proposals in this document.
- Friday 27 July – deadline for consideration by Ofgem of responses
- w/c 30 July – direction issued on level of security cover

1.10 Responses should be sent to:

Fran Gillon
Head of Supplier Failure and Licensing
Ofgem
9 Millbank
London
SW1P 3GE

or by e-mail to Fran.gillon@Ofgem.gov.uk

1.11 It is open to respondents to mark all or part of their responses as confidential.
However, we would prefer it if, as far as possible, responses were provided in a form that can be placed in the Ofgem library and on our website.

1.12 If you have any queries about this consultation then James Richardson (020 7901 7027, e-mail: James.Richardson@Ofgem.gov.uk) or Kristinn Mason (020 7901 7359, e-mail: Kristinn.Mason@Ofgem.gov.uk) will be pleased to help.

2. Legal and regulatory framework

2.1 This section explains the legal and regulatory framework *after* the Utilities Act gas and electricity standard licence conditions come into force. It considers only those conditions that are relevant to:

- the principles used to set the value of the security cover;
- the circumstances in which security cover may be used by a SoLR; and
- the circumstances in which a gas transporter or electricity distribution company may raise a levy to pay some or all of the SoLR's otherwise unrecoverable costs.

Legal framework - Supplier of Last Resort

Licence revocation

2.2 If a gas supplier is insolvent the Authority can currently revoke a gas supply licence by giving not less than 24 hours' notice. After the Utilities Act standard licence conditions come into force, the Authority will be able to revoke an insolvent gas or electricity supplier's licence by giving not less than 24 hours' notice. If it appears to the Authority that circumstances have arisen which would entitle it to revoke a supply licence it can direct one or more other suppliers to be a SoLR for all groups of the failed supplier's gas and electricity customers. The direction to be a SoLR takes effect from the date of revocation and lasts for up to 6 months.

2.3 The Guidance Document describes in more detail the relevant provisions and how Ofgem is likely to use them. For the purposes of this document the main provisions (reproduced at Annex 1) are:

- i) Supply Licence standard condition 28 – Deemed contracts

Schedule 6 to the Electricity Act 1989 (as inserted by Schedule 4 to the Utilities Act) introduces a requirement on all electricity suppliers to have

deemed contract schemes in certain cases⁷. (This is already a requirement of gas suppliers.) The schemes can make different provision for different cases or classes of cases, or for different areas. This means that a SoLR could have a deemed contract scheme that charged different prices to customers of a failed supplier and that these could vary by region.

This licence condition sets out obligations on the licensee in relation to its deemed contracts. These are explained in Annex 2.

ii) Supply Licence standard condition 29 – Supplier of Last Resort

A SoLR shall, unless the Authority agrees otherwise, so far as is reasonably practicable give the Authority at least 5 days' notice of any increase in charges⁸.

The SoLR can charge the failed supplier's customers at a rate that is no greater than:

- (a) such charges as may be expected to approximately equal the SoLR's reasonable costs of supply, plus reasonable profit (this includes provision for the purchase of gas or electricity at short notice); or
- (b) charges set by the Authority for domestic customers when it considers that they would be caused hardship by the SoLR's proposed increase in charges⁹.

A supplier must use its reasonable endeavours to buy gas or electricity as economically as possible in all the circumstances when entering into any new contract in order to comply with its obligations as a SoLR.

⁷ Utilities Act 2000 Schedule 4(3)

⁸ SLC 29(9)

⁹ SLC 29(12), 29(13) and 29(14)

iii) Supply Licence standard condition 29A – Supplier of Last Resort Supply Payments

This condition explains how and how much of its otherwise unrecoverable costs the SoLR can recover from the failed supplier's security cover or by way of a levy on gas transporters or electricity distribution companies. Prior to being appointed as a SoLR the licensee may agree that it will not make such a claim unless it is directed by the Authority to lower its deemed contract rate to domestic customers.

iv) Supply Licence standard condition 33 – Last Resort Supply: Security for Payments

This condition requires licensees to take out and maintain security cover that can be paid to a SoLR in certain circumstances. The value of the security cover is calculated in accordance with principles determined by the Authority. It is based on an amount per domestic premises supplied and an amount per kWh supplied to those premises. A maximum amount is specified in the condition.

v) Transporter/Distribution Company licence standard condition 48 – Last Resort Supply: Payment Claims.

Following approval of a claim by the Authority a gas transporter or electricity distribution company can increase its use of system charges to gas shippers or electricity suppliers in order to compensate a SoLR for its otherwise unrecoverable costs.

Regulatory framework

The Gas and Electricity Markets Authority

- 2.4 The principal objective of the Authority in carrying out its functions is to protect the interests of consumers, wherever appropriate by promoting effective competition¹⁰.

¹⁰ Gas Act 1986 s4 and Electricity Act 1989 s3 (as inserted by the Utilities Act 2000)

The Authority must carry out its functions in the manner it considers is best calculated to further that principal objective having regard to, amongst other things:

- ◆ the need to secure that all reasonable demands for gas and electricity are met; and
- ◆ the need to secure that licence holders are able to finance their activities which are the subject of obligations under the Utilities Act or, as the case may be, the Gas Act 1986 or the Electricity Act 1989.

Ofgem's principles

- 2.5 The Guidance Document explains that, in considering whether to revoke a supplier's licence and appoint a SoLR, Ofgem would take into account (amongst other things) the price that the SoLR proposed to charge different groups of the failed supplier's customers. It explained that Ofgem cannot guarantee that a failed supplier's customers will not have to pay more for their gas or electricity to a SoLR.
- 2.6 The role of SoLR represents a significant logistical challenge to a supplier. It is likely to incur increased administration costs and will have to make additional energy purchases. These will have to be activated and managed within a very short period of time. But there are potentially valuable commercial benefits to a SoLR. It will not have the normal acquisition costs (for example paying commission to doorstep sales agents) and will have the opportunity to convert the customers it has acquired as a SoLR to its normal contracts.
- 2.7 Ofgem therefore believes that it is likely that a number of suppliers will volunteer to be a SoLR. Ofgem does not consider that it would be appropriate, where a supplier is volunteering for the role of SoLR, for the supplier to set its proposed deemed contract charges in anticipation of a subsidy from the failed supplier's security cover or the levy arrangements.
- 2.8 In such circumstances, Ofgem considers that a SoLR should set its charges for customers at a level that reflects the supplier's assessment of its expected costs involved in supplying those customers. It would not be appropriate to charge

customers of a failed supplier less than the actual cost of supplying them, on the basis that the difference would be funded by all other customers through the levy arrangements on distribution and transportation.

- 2.9 Ofgem's proposed approach in appointing a SoLR will, in the first instance, seek a SoLR that has agreed in advance not to make a claim on the failed supplier's security cover or the distributor/transporter for otherwise unrecoverable costs. Using this approach, Ofgem will be able to compare suppliers' proposed tariffs for acting as a SoLR on an equal basis. This is based on the assumption that Ofgem does not require the SoLR to reduce its charges to domestic customers where Ofgem considers that customers would experience hardship. The Guidance Document explained that where Ofgem does require such a reduction in proposed charges¹¹, these reductions in charges would be funded from the failed supplier's security cover. If this proved insufficient the levy arrangements on gas transporters or electricity distribution companies would fund the remainder.

¹¹ SLC29(14)

3. Current position

- 3.1 This section explains the background to and principles used in setting the current security cover for gas suppliers including consideration of the type of unrecoverable costs that a SoLR might have. It explains the maximum amount at which the security cover could be set under the Utilities Act for gas and electricity.

Gas – current position

Licence condition

- 3.2 All gas suppliers that are licensed to supply domestic customers are required by their licence to take out and maintain security cover to provide adequate payment in the event that a SoLR is appointed to take over their customers¹².
- 3.3 When the domestic gas market first opened to competition in April 1996 there was concern about what would happen to the domestic customers of a gas supplier going into receivership. The security cover was designed to protect a SoLR from unrecoverable costs that arose from taking over the failed supplier's domestic customers. The cost of protecting those customers was therefore targeted at the domestic customers who benefited from the protection rather than Industrial and Commercial customers.
- 3.4 The Authority has approved various types of cover. Full details are given at Annex 3 and include:
- a bond from an insurance company;
 - a standby letter of credit from a City of London branch of a bank;
 - a cash deposit; or
 - a bond from the licensee's ultimate holding company (providing it has credit rating of not less than AA- (Standard and Poor's long term) or AA1 (Moody's long term)).

¹² Current SLC 9: Security for payments where last resort directions are given

Setting the existing level of security cover

3.5 For any year the security cover can be set at a maximum of:

- £4 x number of domestic premises expected to be supplied during the year; plus
- 0.0511821p/kWh x amount of gas expected to be supplied

These maxima are increased by the rate of inflation each year.

3.6 The security cover could therefore be set at a maximum of £13.75¹³ per domestic customer (assuming an average consumption of 19,050 kWh a year). The total annual cost to the industry could therefore be in the region of £1.4m¹⁴ (assuming that suppliers would pay a 0.5% risk premium and that there are 19.7 million domestic customers).

3.7 In fact when the domestic gas market was opened to competition in 1996 the value of the security cover was set at:

- £1.00 x number of domestic premises expected to be supplied during the year; plus
- £0.006 per therm (equivalent to 0.0204728p/kWh) x amount of gas expected to be supplied during the year.

3.8 The value of security cover for a customer with an average consumption is therefore £4.90¹⁵ which would give a total annual cost to the industry of close to £0.5m.

3.9 In considering what a cost-reflective level of the security cover would be, Ofgas took two main factors into account:

- what a SoLR can charge customers under its deemed contract; and
- the likely market conditions.

¹³ $(19,050 \times 0.0511821) / 100 + £4$

¹⁴ 0.05% of the charge per premises multiplied by the number of domestic customers.

¹⁵ $(19,050 \times 0.0204728) / 100 + £1 = £4.90$ per premises

- 3.10 The current gas supply standard licence condition allows a SoLR to charge the failed supplier's customers its deemed contract price until a meter reading is obtained (up to 14 days is allowed). After that the SoLR can charge customers its reasonable costs of supplying gas plus a reasonable profit. If the Authority considers that the SoLR's charges would cause hardship to domestic customers it can direct the SoLR to reduce its charges to avoid or mitigate that hardship¹⁶.
- 3.11 Ofgas considered that a SoLR could face additional administration, billing and meter reading costs. This was balanced by the savings to the SoLR on its normal marketing and sign-up costs as many of the failed supplier's former customers would probably sign contracts with it.
- 3.12 Unrecoverable costs were therefore considered likely to fall into three categories:
- where the short term cost of gas exceeded that allowed for in the SoLR's deemed contract in force before a meter reading was obtained (no more than 14 days);
 - bad debt caused by some of the failed supplier's customers not paying the SoLR before they moved to another supplier, although it was assumed that suppliers deemed contract rates would include an allowance for bad debt; and
 - costs incurred because the Authority had directed the SoLR to reduce its charges because they were likely to cause hardship to domestic customers. At the time it was considered unlikely that the cost of gas would be so high as to cause hardship because customers would be likely to transfer quickly to the supplier's normal contract rate. This would be less than its deemed contract rate so customers would only be paying higher prices for a short time.
- 3.13 In practice no supplier's security cover has ever been called.

¹⁶ Current gas supply standard licence condition 5(7)

Electricity – current position

3.14 The Utilities Act standard licence conditions set a maximum amount for the security cover of the sum of:

- £4 per domestic premises expected to be supplied; plus
- 0.21p/kWh x the amount of electricity to be supplied to those premises annually.¹⁷

3.15 This means that the maximum amount could be set at £10.93 per domestic premises (assuming an average annual consumption of 3,300 kWh) at a total annual cost to the industry (and, ultimately, customers) of £14m¹⁸ (assuming that suppliers would pay 0.5% interest and that there are 26 million domestic customers). If the actual level of the security cover in electricity was set at the same level as gas it would be around £3.89 per customer¹⁹; a total annual cost of around £0.5m.

¹⁷ Utilities Act Electricity Standard Licence Condition 33 (7)

¹⁸ $((3300 \times 0.21)/100 + £4) \times 26m \times 0.5\%$

¹⁹ 0.05% of the charge per premises multiplied by the number of domestic customers

4. Factors to consider

4.1 This section discusses whether the cost of having security cover can be justified any more given the interactions between:

- Ofgem's preferred method of selecting a SoLR;
- a SoLR's ability to charge the failed supplier's customers a deemed contract rate that can reflect its costs, including the cost of buying gas or electricity at short notice;
- the circumstances in which Ofgem might consider that domestic customers could suffer hardship because of the high deemed contract price;
- the availability of a levy;
- the cost to the industry (and, ultimately, customers) of having security cover including the particular affect that any requirement for security cover would have on smaller suppliers; and
- the regulatory cost of having security cover.

SoLR selection

4.2 Ofgem considers that a SoLR should set its charges for customers at a level that reflects its assessment of the expected costs of supplying those customers. The charges should not be based on an assumption that a subsidy will be available from either the failed supplier's security cover or a levy on use of system charges. We recognise however that the standard licence conditions allow us to direct a SoLR to lower its charges if we consider that a proposed increase would cause hardship to domestic customers.

4.3 In the first instance Ofgem would aim to select a SoLR that agrees not to make any claim for unrecovered costs unless it is directed to lower its costs to domestic customers. If no supplier consented to being a SoLR, Ofgem would have to direct a

supplier against its wishes. In these circumstances Ofgem could not expect the supplier to agree not to make a claim.

4.4 There would be two circumstances in which a claim might be made:

- i) a volunteer SoLR that had consented not to make a claim but had been directed by Ofgem to reduce its deemed contract price. The unrecoverable costs would include the cost of reducing the deemed contract price to prevent or mitigate hardship to domestic customers; or
- ii) a supplier directed to be a SoLR against its will that had not consented not to make a claim. Unrecoverable costs could include (but might not be limited to) costs associated with a reduction in price to prevent or mitigate hardship to domestic customers.

4.5 Ofgem believes that there are potentially valuable commercial benefits of being SoLR. These include no normal acquisition costs and the opportunity to convert the customers it has acquired as a SoLR to normal contracts. Against this background, several gas suppliers have volunteered as potential SoLRs.

4.6 All these factors indicate that there is probably no need for suppliers to have security cover in place.

Deemed contracts

4.7 When a customer uses gas (or electricity after the full provisions of the Utilities Act come into force) otherwise than under a contract, a deemed contract comes into existence between the supplier and the customer. For example a deemed contract between the relevant suppliers and the customers will exist when someone moves into a house and starts to use gas and electricity even though they have not agreed a contract with the supplier. A deemed contract will also exist when a supplier starts to supply gas or electricity as a SoLR. The deemed contract price for customers being supplied by a SoLR is likely to be more than for a similar customer in other circumstances because of the additional costs (such as buying gas or electricity at short notice) that a SoLR will have.

- 4.8 The Guidance Document explains the criteria that Ofgem will use to select one or more suppliers to be a SoLR. Selection will be on the basis of information supplied by potential SoLRs about how they meet the criteria. One of the criteria that will be considered will be each potential SoLR's deemed contract terms for the different groups of the failed supplier's customers.
- 4.9 Deemed contract schemes may make different provision for different cases or classes of cases or for different areas. This means, for instance, that there can be different charges for domestic, Industrial and Commercial customers, prepayment meter customers and (electricity) Half Hourly customers; price may also vary by payment method. These charges can vary depending on which part of the country the customer is situated. A supplier might have a different deemed contract price for the same group of customers in normal circumstances compared to supplying them as a SoLR.
- 4.10 The SoLR direction comes into effect on revocation of the failed supplier's licence. At this point the SoLR will be able to charge the failed supplier's customers for gas and/or electricity on the basis of its deemed contract rates for SoLR customers. As soon as reasonably practicable after appointment, the SoLR must notify the failed supplier's customers of its charges²⁰.
- 4.11 If the SoLR wants to increase its charges it must (as far as reasonably practicable and unless the Authority consents otherwise) give the Authority at least 5 days notice²¹. If the Authority considers that any proposed increase in charges would cause hardship to domestic customers it may direct the SoLR to reduce them to a specified amount in order to reduce or mitigate the hardship. The Authority can only order a reduction following the proposal of an increase by the licensee. The Authority cannot direct the SoLR to charge less than its (non-SoLR) deemed contract price for comparable premises with similar metering arrangements.
- 4.12 There is no equivalent provision for non-domestic customers. They could therefore be charged the full cost of any increase in the SoLR's deemed contract prices.

²⁰ SLC 29(7)

²¹ SLC 29(9)

- 4.13 In normal circumstances the SoLR deemed contract rate cannot be greater than the SoLR's reasonable costs (including the cost of buying gas at short notice) together with reasonable profit²². However if the Authority has directed the SoLR to reduce its charges because it considers that they would cause hardship to domestic customers, the SoLR would have to charge less than its reasonable costs plus reasonable profit. Nevertheless it would be able to make a claim to transporters or distribution companies for a levy to cover its otherwise unrecoverable costs.
- 4.14 These issues suggest that there is probably no need for suppliers to have to provide security cover.

Hardship

- 4.15 The hardship provision applies only to domestic customers. It is designed to deal with a situation where the short term cost of gas or electricity that the SoLR is buying is exceptionally high and even though a domestic customer would only be paying these charges for a short period the price would be considered to cause them hardship. Hardship is not defined in the standard licence conditions.
- 4.16 In considering what level of price increase might cause hardship to domestic customers Ofgem is likely to take into account the following information:
- the savings that an average customer had made by switching to the failed supplier;
 - the size of the proposed price increase by the SoLR compared to that of other SoLRs (if there is more than one);
 - the difference between the SoLR's or other suppliers normal deemed contract rate and its proposed price increase;
 - price rises faced by other customers (if any);
 - the different increases faced by customers using different payment methods;

²² SLC29(12)

- the number of customers affected.

4.17 Views are invited on these suggestions and on other factors that Ofgem might consider would be likely to cause hardship to domestic customers.

Availability of a levy

4.18 If a SoLR makes a claim for payment against a failed supplier's security cover and the security cover is less than the relevant amount claimed, the SoLR may claim from the relevant gas transporter or electricity distribution company for the underpayment. The transporter or distribution company then increases its use of system charges so that the increased revenue equals the amount claimed by the SoLR. This increase (often called a levy) may then be passed on to customers. In electricity, the levy has a regional effect as Distribution Companies have regional distribution areas. In gas the effect of the levy is Great Britain wide.

4.19 This means that even if the value of the security cover were set by Ofgem to zero a SoLR would (subject to approval by Ofgem) still be able to recover its otherwise unrecoverable costs following a direction to lower its charges to prevent hardship to domestic customers.

4.20 The advantage of a levy is its *ex post* nature - it is raised only if a supplier fails. Although customers of unaffected suppliers would face higher charges in the event of a levy, they would have avoided the charges their supplier would have had to make to finance security cover.

4.21 *Ex ante* methods are generally preferred when an outcome has a high probability, or it is a frequent occurrence. *Ex post* regulation is preferred when an outcome has a low probability, or it is infrequent. Given that so far the need for a SoLR seems quite low an *ex post* approach seems favourable.

Cost to suppliers

4.22 The total annual cost to gas suppliers of providing security cover at the current level is estimated at close to £0.5m; an equivalent level in electricity would cost a similar

sum (see paragraphs 3.8 and 3.14). The total annual cost to the industry (and ultimately customers) could therefore be around £1 million.

4.23 The provision of security cover imposes a cost on the supplier because:

- if a supplier has to provide cash it will have to borrow the money at a corporate rate (including a risk premium) but would only receive a market rate of interest on the money;
- if a supplier has to provide a letter of credit or insurance bond it will have to pay a risk premium to the bank or insurance company; and
- in addition, the provision of security cover in any form uses up some of the financial capacity of the supplier. This means that that money is unavailable for use elsewhere.

4.24 The nature of the types of security cover accepted by Ofgem mean that larger suppliers are likely to be able to provide security cover from their ultimate holding company. This option is less likely to be available to smaller suppliers who are more likely to have to provide other types of security cover. The cost of financing the security cover is therefore greater for smaller suppliers.

4.25 The cost of providing the security cover is likely to be passed on to customers. Smaller suppliers are likely to face higher costs for credit cover and so their customers may be charged proportionately more. This may make smaller suppliers less competitive.

4.26 The method of calculating the security cover is likely to adversely affect smaller suppliers wishing to expand their customer base. Because the value of the security cover is based in part on the number of domestic premises *expected* to be supplied during a year a supplier may have to find money for a security cover for customers it has not yet acquired (but expects to acquire during the year).

4.27 Even though no gas supplier's security cover has ever been called, they (and ultimately customers) have had to pay for providing it since the market opened to

competition. This suggests that there may be no need to require security cover in future.

Regulatory cost

4.28 Deciding what level to set the security cover would require a substantial amount of work by Ofgem. It would have to attempt to take into account:

- the likely level of a SoLR's deemed contract charges (so that any unrecoverable costs could be estimated) even though this would depend to some extent on market conditions at the time;
- the risk of additional bad debt to the SoLR from the failed supplier's customers transferring without paying their bills; and
- the likely condition of a failed supplier's information systems (a poorly maintained system could lead to increased costs for the SoLR).

4.29 The information from suppliers to carry out this process and update the information on a regular basis would increase the regulatory burden on suppliers and could further raise prices for customers.

Discussion

4.30 The advantage of setting security cover is that the cost of protecting domestic customers from price increases that might cause hardship was targeted at the customers who benefited from the protection (rather than Industrial and Commercial customers). However even if the requirement for a bond was set at zero, domestic customers can still be protected from high prices where Ofgem considers that customers will be caused hardship. A claim on security cover from the SoLR for its otherwise unrecoverable costs would need to be made and subject to Ofgem's agreement, a levy on use of system charges applied.

4.31 On balance having considered the potential impact of all the above issues on customers and on competition, Ofgem proposes that the level of the security cover

in both gas and electricity should be set to zero at the point the Utilities Act standard licence conditions are introduced.

5. Conclusion

Summary

5.1 This document has explained the following:

- the requirement under the Utilities Act for domestic gas and electricity suppliers to provide security cover in line with principles set by the Authority;
- the circumstances in which a SoLR might be able to claim for its otherwise unrecoverable losses;
- the availability of a levy from transportation and/or distribution companies if the failed supplier's security cover is insufficient;
- the cost to the industry (and ultimately customers) of providing security cover; and
- the adverse effect on smaller suppliers of having to provide security cover and potential effect on competition that this has.

Ofgem's Proposal

5.2 Having considered the potential impact of all these issues on customers and on competition Ofgem proposes that the level of the security cover in both gas and electricity should be set to zero at the point the Utilities Act standard licence conditions are introduced.

Views invited

5.3 Views are welcomed on any part of this document but in particular on:

- in what circumstances domestic customers could be caused hardship if a SoLR increased its deemed contract price; and
- the proposal that gas and electricity security cover should be set to zero.

Annex 1 – Utilities Act Standard Licence Conditions

Gas – Suppliers Standard Licence Conditions

Condition 28. Deemed Contracts

1. This condition sets out the obligations placed on the licensee in relation to its deemed contracts.
2. The licensee shall use its reasonable endeavours to ensure the terms of its deemed contracts are not unduly onerous.
3. In the case of any class of domestic customers or of any class of non-domestic customers, the terms of a deemed contract shall be taken to be unduly onerous if the revenue derived from supplying gas to customers of the class in question on those terms -
 - (a) significantly exceeds the costs of supply of gas; and
 - (b) exceeds such costs of supply by significantly more than the licensee's revenue exceeds costs of supply in the case of the generality of its domestic customers or, as the case may be, in the case of the generality of its non-domestic customers (excluding in each case customers supplied in accordance with standard condition 29 (Supplier of Last Resort)).
4. For the purposes of paragraph 3 "costs of supply" shall not include any costs attributable to any promotional, marketing or advertising activities of the licensee.
5. The licensee shall, as soon as is reasonably practicable after determining or revising (in whole or in part) any of the terms of its deemed contracts, send a copy to the Authority.
6. At the request of any person, the licensee shall supply that person with a copy of the terms of its deemed contracts.

7. The licensee shall ensure that the terms of its deemed contracts are such that, in their application to gas supplied under a last resort supply direction, the amount of any charges for gas so supplied complies with the provisions of paragraphs 13, 14 and 16 of standard condition 29 (Supplier of Last Resort).
8. Where the licensee supplies a customer with gas under a deemed contract, it shall use its reasonable endeavours to furnish the customer with -
 - (a) details of the principal terms of that deemed contract;
 - (b) written notice that contracts on terms other than deemed contracts may be available and as to how information can be obtained as to any such terms; and
 - (c) where the customer is a domestic customer, an accurate summary of the principal terms of domestic supply contracts available.
9. The licensee shall ensure the terms of its deemed contracts -
 - (a) include such term as is mentioned in paragraph 4 of standard condition 14 (Security and Emergency Arrangements);
 - (b) where the customer is a non-domestic customer, include such term as is mentioned in paragraph 3 of standard condition 14 (Security and Emergency Arrangements);
 - (c) make the like provision as is required in the case of a contract by paragraph 1 of standard condition 29B (Provision for Termination upon a Direction);
 - (d) where the customer is a domestic customer, make the like provision as is required in the case of a contract by standard condition 45 (Security Deposits);

- (e) where the customer is a domestic customer, make the like provision as is required in the case of a contract by paragraph 1 of standard condition 47 (Termination of Contracts in Specified Circumstances); and
 - (f) provide that where the customer intends to be supplied with gas at the premises under a contract with the licensee or another gas supplier, the deemed contract does not terminate but continues to have effect until the time when the licensee or, as the case may be, the other gas supplier begins to supply gas under a contract, at which time the deemed contract ceases to have effect.
10. Subject to paragraph 17 of standard condition 29 (Supplier of Last Resort), nothing in paragraph 9 shall be construed as preventing the inclusion of terms providing for the termination of a deemed contract which are additional to and do not derogate from those required by sub-paragraphs (c), (e) and (f) of paragraph 9.
11. In determining the number of kilowatt hours of gas which are to be treated as supplied or taken under a deemed contract, the licensee shall act on a reasonable basis, taking into account available gas consumption data for the premises in question and other relevant factors.
12. Paragraphs 2 to 4 and 8(b) shall not apply in relation to customers supplied with gas in accordance with standard condition 29 (Supplier of Last Resort).
13. Where, in preparation for a restriction or revocation of its licence, the licensee is making arrangements for securing continuity of supply for its customers supplied with gas in pursuance of deemed contracts, it shall, except in so far as the Authority otherwise consents –
- (a) in making those arrangements, reasonably endeavour to select one or more new suppliers which offer or will offer comparable services at the lowest available cost; and
 - (b) use its reasonable endeavours to give its customers likely to be affected reasonable notice of those arrangements.

Condition 29. Supplier of Last Resort

1. Where this paragraph applies, the Authority may, by notice, direct the licensee to supply gas in accordance with this condition ("the last resort supply direction").
2. Paragraph 1 applies where it appears to the Authority that -
 - (a) circumstances have arisen which would entitle the Authority to revoke the supply licence of a gas supplier other than the licensee ("the other supplier"); and
 - (b) the licensee could comply with the last resort supply direction without significantly prejudicing its ability -
 - (i) to continue to supply its customers; and
 - (ii) to fulfil its contractual obligations for the supply of gas.
3. The last resort supply direction shall take effect from the date of revocation of the other supplier's licence and shall continue for such period (being no longer than 6 months) specified in the direction.
4. The licensee shall supply gas to customers of the other supplier at such premises as are specified or described in the last resort supply direction.
5. The licensee shall not be required under this condition to supply gas to a particular customer at particular premises which it would not be required to supply by virtue of paragraph 3 of standard condition 32 (Duty to Supply Domestic Customers).
6. Within 2 working days of the last resort supply direction taking effect, the licensee shall send to the Authority, for its approval, a draft of the notice the licensee proposes to send to each of the premises specified or described in the direction.

7. As soon as reasonably practicable after the Authority has approved the form and content, except as to the level of charges payable for supply of gas under the direction or an explanation of how the charges are determined, of the notice sent to it pursuant to paragraph 6, the licensee shall send a copy of the notice to each of the premises specified or described in the last resort supply direction.
8. The notice to be sent to all premises specified or described in the last resort supply direction, shall -
 - (a) inform the customer in question that, notwithstanding any contract or deemed contract the customer may have had with the other supplier, the customer is no longer supplied by that supplier and has not been supplied by the other supplier since the date on which the direction took effect;
 - (b) inform the customer in question that the licensee became the supplier of gas to the customer from the date the direction took effect; and
 - (c) set out the charges payable for the supply of gas under the direction or an explanation of how the charges are determined.
9. Unless the Authority otherwise consents, the licensee shall, so far as is reasonably practicable, give the Authority at least 5 days' notice of any increase in charges for the supply of gas to premises in accordance with the last resort supply direction.
10. The licensee shall use all reasonable endeavours to secure a meter reading at each of the premises specified or described in the last resort supply direction within 14 days of the direction taking effect.
11. The licensee is not obliged to secure a meter reading where-
 - (a) the Authority accepts that it would not be feasible or economic to do so; or
 - (b) to do so would necessitate the entering of particular premises without the consent of the occupier or the seeking of entry on more than one occasion.

12. The licensee may charge for the supply of gas to the premises specified or described in the last resort supply direction at a rate which is no greater than -

(a) such charges as may be expected, in aggregate, approximately to equal the licensee's reasonable costs of supply (including such costs attributable to the purchase of gas at short notice) together with a reasonable profit; or

(b) the charges set out in the notice given by the Authority under paragraph 13.

13. Where, within 5 days of receipt by the Authority of the notice given by the licensee under paragraph 9, the Authority determines that charges proposed by the licensee would be likely to cause hardship to domestic customers, it may direct by notice in writing to the licensee that licensee's charges shall not exceed those which it specifies in the notice as being likely to avoid or mitigate such hardship.

14. The licensee shall not be required by paragraph 12(b) to make charges which are less than those which would be made under the licensee's deemed contract for comparable premises with similar metering arrangements supplied with gas otherwise than in accordance with a last resort supply direction.

15. Unless the Authority otherwise consents, the licensee shall ensure that its terms and conditions (including charges) for a supply pursuant to a last resort supply direction do not show any undue preference or undue discrimination as between any persons or classes of persons.

16. Notwithstanding anything in standard condition 28 (Deemed Contracts), the terms of the licensee's deemed contract scheme for the supply of gas to premises in accordance with a last resort supply direction may provide that, until the direction ceases to have effect, the customer may not terminate his deemed contract except:

(a) with the consent of the licensee;

(b) on taking a supply at the premises under a contract with the licensee or another gas supplier; or

(c) on ceasing to take gas at the premises.

17. Where the licensee enters into any new contract for the purchase of gas in order to comply with its obligations under this condition, it shall use reasonable endeavours to make the purchase as economically as possible in all the circumstances.

Condition 29A. Supplier of Last Resort Supply Payments

1. This condition sets out how, and how much, the licensee may recover in respect of any losses it incurs in complying with a last resort supply direction given under standard condition 29 (Supplier of Last Resort).
2. Except in relation to a claim made following a direction by the Authority pursuant to paragraph 13 of standard condition 29 (Supplier of Last Resort), paragraphs 3 to 12 of this condition shall not have effect in this licence in relation to any claim under sub-paragraph 3(a), sub-paragraph 3(b) or both those sub-paragraphs if before a last resort supply direction is issued to the licensee it gives notice of consent to that effect to the Authority.
3. Where the licensee intends to make a claim for the payment of monies ("last resort supply payments") pursuant to –

- (a) standard condition 33 (Last Resort Supply: Security for Payments), as incorporated in the licence of the other supplier (as defined in paragraph 2 of standard condition 29 (Supplier of Last Resort));
- (b) standard condition 48 (Last Resort Supply: Payment Claims) of the standard conditions of the gas transporters licence,

the licensee shall in respect of each claim made notify the proposal to the Authority. The notification must include a calculation of the relevant amount with supporting information and must be received by the Authority within 6 months of the last resort supply direction to which it relates ceasing to have effect.

4. Subject to paragraphs 5 and 6, the total sum of last resort supply payments claimed by the licensee ("the relevant amount") shall not exceed the amount by which -
 - (a) the aggregate costs (including interest on working capital) reasonably incurred by the licensee in supplying gas to premises in pursuance of the last resort supply direction, together with a reasonable profit,

are greater than

- (b) the aggregate amounts recovered by the licensee by way of charges for gas supplied to premises in pursuance of the last resort supply direction (after taking all reasonable steps to recover such charges).
- 5. The Authority may, within 3 months of the notification under paragraph 3 and after consulting the licensee, determine that an amount other than that notified to it by the licensee is a more accurate calculation of the relevant amount.
- 6. Where the Authority makes a determination in pursuance of paragraph 5, the amount specified in the determination shall be treated as the relevant amount for the purposes of the following paragraphs of this condition.
- 7. In respect of a claim of the type mentioned in sub-paragraph 3(a), the licensee shall, within 6 months of the last resort supply direction to which it relates ceasing to have effect, submit the claim to the trustee appointed by the Authority pursuant to standard condition 33 (Last Resort Supply: Security for Payments) of the supply licence of the other supplier (as defined in paragraph 2 of standard condition 29 (Supplier of Last Resort)) specifying the relevant amount.
- 8. Where a last resort supply payment made to the licensee by the trustee referred to in paragraph 7 is less than the relevant amount, the licensee may claim from the relevant gas transporters further last resort supply payments pursuant to paragraphs 9 and 10.
- 9. Last resort supply payments claimed by the licensee from the relevant gas transporters shall not in aggregate exceed the amount by which the payment (if any) made to the licensee by the trustee referred to in paragraph 7 fell short of the relevant amount (the "under payment").
- 10. In respect of a claim of the type mentioned in sub-paragraph 3(b), the licensee shall, within 6 months of the last resort supply direction to which it relates ceasing to have effect, submit the claim to each relevant gas transporter (so far as is reasonably practicable all claims shall be submitted at the same time) specifying -
 - (a) their respective proportion of the under payment (as defined in paragraph 9); and

(b) whether payment is to be made by quarterly or monthly instalments.

11. The respective proportion shall be the same as the proportion of the total number of premises in Great Britain to which gas is conveyed by the relevant transporter in question.

12. In this condition "relevant transporter" means a transporter in whose licence Section C has effect.

Condition 29B. Provision for Termination Upon a Direction

1. The licensee shall not enter into a contract for the supply of gas to any premises whether or not the contract is for a specified period unless it provides that it shall terminate upon a last resort direction given to a gas supplier other than the licensee, in pursuance of standard condition 29 (Supplier of Last Resort) of that supplier's licence coming into effect in relation to the premises in question.
2. Where a domestic supply contract is for both the supply of gas and the provision of other goods or services, any reference in this condition to its termination is a reference to its termination in respect of the supply of gas alone.

Condition 33. Last Resort Supply: Security for Payments

1. The licensee shall establish and maintain arrangements ("security arrangements") in accordance with this condition.
2. If licensed to supply gas to domestic customers, the licensee shall establish security arrangements by -
 - (a) taking out a bond or other instrument approved by the Authority; or
 - (b) making other arrangements as the Authority may approve,to secure such sum of money as is calculated in accordance with principles determined by the Authority and notified to the licensee but in any case not exceeding the maximum sum set out in paragraph 7.
3. The security arrangements established by the licensee shall provide that, in the event of the Authority giving directions to one or more other gas suppliers under standard condition 29 (Supplier of Last Resort) as incorporated in those suppliers' licences to supply the licensee's domestic customers, there shall be payable, to such person as the Authority may appoint ("the trustee"), such sums, or instalments of sums, as the trustee may (after consulting the Authority) request, subject, however, to paragraphs 4 and 5.
4. The Authority may, at any time, vary the principles determined under paragraph 2 following consultation with the licensee, all other suppliers and the Consumer Council.
5. The licensee shall maintain the security arrangements and shall –
 - (a) ensure that the arrangements are not terminated or varied (save for the purpose of extending their duration or in accordance with sub-paragraph (b)) other than with the prior consent of the Authority; and
 - (b) at least once in each year –

- (i) consider whether the sum secured by the arrangements requires to be revised in order to ensure that it continues to be set in compliance with the principles determined by the Authority (as varied from time to time); and
 - (ii) where such sum requires revision, establish and thereafter maintain additional or amended arrangements with the approval of the Authority.

- 6. Where the Authority reasonably considers that the security arrangements established and maintained by the licensee do not secure a sum calculated in accordance with the principles determined by the Authority (as varied from time to time), it may at any time, issue a direction to the licensee requiring the licensee to establish and thereafter maintain additional or amended arrangements to secure such sums as may be specified in the direction.

- 7. Subject to paragraph 8, the maximum sum referred to in paragraph 2 shall be determined for each calendar year and shall be the aggregate of –
 - (a) the product of the number, in that year, of domestic premises expected to be supplied and such sum, in respect of each premises, not exceeding £4, as may have been approved by the Authority-
 - (i) for that year, and
 - (ii) for the purposes of this condition generally,

and have been so approved for the calendar year beginning on 1 January 2001, not later than 1 month after the date on which the Secretary of State determines these standard conditions pursuant to sub-section 81(2) of the Utilities Act 2000, and for any subsequent calendar year, not later than 30 September in the previous year; and
 - (b) the product of the amount of gas expected to be supplied, expressed in kilowatt hours, and such sum per kilowatt hour, not exceeding 0.05p per kilowatt hour, as may have been approved by the Authority as aforesaid,

so, however, that if the Authority fails to approve, for the purposes of sub-paragraph (a) or (b) and as therein mentioned, an amount for any year, this paragraph shall have effect as if it had approved, for that year, the amount last so approved by it for a previous year.

8. In the application of paragraph 7, each of the maximum amounts specified in sub-paragraphs (a) and (b) (separately the "specified amount") thereof shall be adjusted in accordance with paragraph 9 to produce the adjusted amount.
9. The adjusted amount referred to in paragraph 8 shall be the specified amount multiplied by x , where x is obtained by dividing the retail price index for the first month of the year beginning with an anniversary of [1 April 2001] by the retail price index for the month beginning with [1 April 2001]; and any reference in this paragraph to the retail price index is a reference to the general index of retail prices (for all items) published by the Office for National Statistics; and if that index is not published for any month that reference shall be read as a reference to any substituted index or index figure published by that office for that month.

Gas – Transporters Licence

Condition 48. Last Resort Supply: Payment Claims

1. This condition sets out the circumstances in which the licensee shall increase its transportation charges in order to compensate any gas supplier (a “claimant”) which claims for losses that it has incurred in complying with a last resort supply direction.
2. The following provisions apply where the licensee receives from a claimant a valid claim for a last resort supply payment.

3. For the purposes of this condition –

“last resort supply direction” and “last resort supply payment” have, respectively the meanings given to them in standard conditions 29 (Supplier of Last Resort) and 29A (Supplier of Last Resort Supply Payments) of the standard conditions of the gas suppliers licence.

“price control condition” means any condition of the licence which places a monetary limitation on the transportation charges which may be levied or the transportation revenue which may be recovered by the licensee during a given period;

“relevant year” means, in relation to any valid claim -

- (a) where the claim was received by the licensee at least 60 days before the beginning of a year, that year; or
- (b) where the claim was received by the licensee less than 60 days before the beginning of a year, the next year.

“specified amount” means the amount specified on a valid claim together with interest calculated in accordance with paragraph 4;

“valid claim” means a claim for which a claimant has been give a consent by the Authority pursuant to standard condition 29A (Supplier of Last Resort Supply Payments) of the standard conditions of the gas suppliers licence; and

“year” means a period of 12 months beginning with 1st April.

4. The interest referred to in paragraph 3 is simple interest for the period commencing with the date on which the claim was received by the licensee and ending with the date which is 61 days before the start of the relevant year, except where that period is of 30 days or less, in which case no interest shall be payable.
5. Where the licensee receives a valid claim it shall, during the relevant year, increase its transportation charges during that year which relate to the conveyance of gas to premises (and secondary sub-deduct premises to which gas is conveyed as contemplated by sub-deduct arrangements) to such an extent as it reasonably estimates to be appropriate to secure that the consequential increase in its revenue equals the specified amount.
6. The licensee shall, during, or as soon as practicable after the end of, the relevant year, pay to the claimant, by quarterly or monthly instalments (as specified in the claim), the amount of that consequential increase in revenue mentioned in paragraph 5 to the extent that it does not exceed the specified amount.
7. If the amount paid to the claimant under paragraph 6 is less than the specified amount, the licensee shall in the following financial year –
 - (a) pay to the claimant (in accordance with any directions given by the Authority) the shortfall together with 12 months’ interest thereon; and
 - (b) increase the charges referred to in paragraph 5 during the year following the relevant year to such extent as it reasonably estimates to be appropriate to secure that the

consequential increase in its revenue equals the amount of that shortfall together with 12 months' interest thereon.

8. If the amount of the consequential increase mentioned in paragraph 5 exceeds the specified amount, the licensee shall, during the year following the relevant year, decrease the charges referred to in paragraph 5 to the extent that it reasonably estimates to be necessary in order to reduce its transportation revenue for that year by an amount equal to the excess together with 12 months' interest thereon.
9. Any question whether any estimate for the purposes of paragraph 5, 7 or 8 is a reasonable one shall be determined by the Authority.
10. The licensee shall not enter into any transportation arrangements with a gas shipper which do not permit variation of its transportation charges in pursuance of this condition.
11. The provisions of this condition shall have effect notwithstanding any of the provisions of standard condition 4 (Charging of Gas Shippers – General).
12. In calculating the licensee's transportation revenue during any period for the purposes of a price control condition any increase or decrease in revenue attributable to the licensee's compliance with this condition shall be treated as if it had not occurred.
13. The licensee shall prepare, in respect of each year in which it increases or decreases charges in pursuance of paragraph 5, 7 or 8, a statement showing -
 - (a) the aggregate amount of its revenue derived from increases in charges in pursuance of paragraph 5;
 - (b) the aggregate amount of its revenue derived from increases in charges in pursuance of paragraph 7;

- (c) the aggregate amount of the decrease in its revenue resulting from decreases in charges in pursuance of paragraph 8, and
- (d) in the case of each last resort supply payment, the aggregate payments to the claimant made in respect of the year in question (whenever those payments were made).

14. The licensee shall give the statements referred to in paragraph 13 to the Authority within the first 4 months of the year following that to which they relate.

15. On giving the statement mentioned in paragraph 13(d) to the Authority, the licensee shall publish it in such manner as, in the reasonable opinion of the licensee, will secure adequate publicity for it.

16. Where the licensee receives more than one claim for a last resort payment, this condition (other than sub-paragraphs 13(a), (b) and (c)) shall apply separately as respects each separate claim but in so far as it results in changes to the licensee's transportation charges it shall have the cumulative effect of such separate applications.

Electricity – Suppliers Standard Licence Conditions

Condition 28. Deemed Contracts

1. This condition sets out the obligations placed on the licensee in relation to its deemed contracts.
2. The licensee shall use its reasonable endeavours to ensure the terms of its deemed contracts are not unduly onerous.
3. In the case of any class of domestic customers or of any class of non-domestic customers, the terms of a deemed contract shall be taken to be unduly onerous if the revenue derived from supplying electricity to customers of the class in question on those terms -
 - (a) significantly exceeds the costs of supply of electricity; and
 - (b) exceeds such costs of supply by significantly more than the licensee's revenue exceeds costs of supply in the case of the generality of its domestic customers or, as the case may be, in the case of the generality of its non-domestic customers (excluding in each case customers supplied in accordance with standard condition 29 (Supplier of Last Resort)).
4. For the purposes of paragraph 3 "costs of supply" shall not include any costs attributable to any promotional, marketing or advertising activities of the licensee.
5. The licensee shall, as soon as is reasonably practicable after determining or revising (in whole or in part) any of the terms of its deemed contracts, send a copy to the Authority.
6. At the request of any person, the licensee shall supply that person with a copy of the terms of its deemed contracts.
7. The licensee shall ensure that the terms of its deemed contracts are such that, in their application to electricity supplied under a last resort supply direction, the amount of any charges for electricity so supplied complies with the provisions of paragraphs 13, 14 and 16 of standard condition 29 (Supplier of Last Resort).

8. Where the licensee supplies a customer with electricity under a deemed contract, it shall use its reasonable endeavours to furnish the customer with -
- (a) details of the principal terms of that deemed contract;
 - (b) written notice that contracts on terms other than deemed contracts may be available and as to how information can be obtained as to any such terms; and
 - (c) where the customer is a domestic customer, an accurate summary of the principal terms of domestic supply contracts available.
9. The licensee shall ensure the terms of its deemed contracts -
- (a) make the like provision as is required in the case of a contract by paragraph 1 of standard condition 29B (Provision for Termination upon a Direction);
 - (b) where the customer is a domestic customer, make the like provision as is required in the case of a contract by standard condition 45 (Security Deposits);
 - (c) where the customer is a domestic customer, make the like provision as is required in the case of a contract by paragraph 1 of standard condition 47 (Termination of Contracts in Specified Circumstances); and
 - (d) provide that where the customer intends to be supplied with electricity at the premises under a contract with the licensee or another electricity supplier, the deemed contract does not terminate but continues to have effect until the time when the licensee or, as the case may be, the other electricity supplier begins to supply electricity under a contract, at which time the deemed contract ceases to have effect.
10. Subject to paragraph 17 of standard condition 29 (Supplier of Last Resort), nothing in paragraph 9 shall be construed as preventing the inclusion of terms providing for the termination of a deemed contract which are additional to and do not derogate from those required by sub-paragraphs (a), (c) and (d) of paragraph 9.

11. In determining the number of kilowatt hours of electricity which are to be treated as supplied or taken under a deemed contract, the licensee shall act on a reasonable basis, taking into account available electricity demand data for the premises in question and other relevant factors.
12. Paragraphs 2 to 4 and sub-paragraph 8(b) shall not apply in relation to customers supplied with electricity in accordance with standard condition 29 (Supplier of Last Resort).
13. Where, in preparation for a restriction or revocation of its licence, the licensee is making arrangements for securing continuity of supply for its customers supplied with electricity in pursuance of deemed contracts, it shall, except in so far as the Authority otherwise consents
- (a) in making those arrangements, reasonably endeavour to select one or more new suppliers which offer or will offer comparable services at the lowest available cost; and
 - (b) use its reasonable endeavours to give its customers likely to be affected reasonable notice of those arrangements.

Condition 29. Supplier of Last Resort

1. Where this paragraph applies, the Authority may, by notice, direct the licensee to supply electricity in accordance with this condition ("the last resort supply direction").
2. Paragraph 1 applies where it appears to the Authority that -
 - (a) circumstances have arisen which would entitle the Authority to revoke the supply licence of an electricity supplier other than the licensee ("the other supplier"); and
 - (b) the licensee could comply with the last resort supply direction without significantly prejudicing its ability -
 - (i) to continue to supply its customers; and
 - (ii) to fulfil its contractual obligations for the supply of electricity.
3. The last resort supply direction shall take effect from the date of revocation of the other supplier's licence and shall continue for such period (being no longer than 6 months) specified in the direction.
4. The licensee shall supply electricity to customers of the other supplier at such premises as are specified or described in the last resort supply direction.
5. The licensee shall not be required under this condition to supply electricity to a particular customer at particular premises which it would not be required to supply by virtue of subparagraphs 2(b) to (e) of standard condition 32 (Duty to Supply Domestic Customers).
6. Within 2 working days of the last resort supply direction taking effect, the licensee shall send to the Authority, for its approval, a draft of the notice the licensee proposes to send to each of the premises specified or described in the direction.
7. As soon as reasonably practicable after the Authority has approved the form and content, except as to the level of charges payable for supply of electricity under the direction or an explanation of how the charges are determined, of the notice sent to it pursuant to

paragraph 6, the licensee shall send a copy of the notice to each of the premises specified or described in the last resort supply direction.

8. The notice to be sent to all premises specified or described in the last resort supply direction, shall -
 - (a) inform the customer in question that, notwithstanding any contract or deemed contract the customer may have had with the other supplier, the customer is no longer supplied by that supplier and has not been supplied by the other supplier since the date on which the direction took effect;
 - (b) inform the customer in question that, the licensee became the supplier of electricity to the customer from the date the direction took effect; and
 - (c) set out the charges payable for the supply of electricity under the direction or an explanation of how the charges are determined.
9. Unless the Authority otherwise consents, the licensee shall, so far as is reasonably practicable, give the Authority at least 5 days notice of any increase in charges for the supply of electricity to premises in accordance with the last resort supply direction.
10. The licensee shall use all reasonable endeavours to secure a meter reading at each of the premises specified or described in the last resort supply direction within 14 days of the direction taking effect.
11. The licensee is not obliged to secure a meter reading where-
 - (a) the Authority accepts that it would not be feasible or economic to do so; or
 - (b) to do so would necessitate the entering of particular premises without the consent of the occupier or the seeking of entry on more than one occasion.
12. The licensee may charge for the supply of electricity to the premises specified or described in the last resort supply direction at a rate which is no greater than -

- (a) such charges as may be expected, in aggregate, approximately to equal the licensee's reasonable costs of supply (including such costs attributable to the purchase of electricity at short notice) together with a reasonable profit; or
- (b) the charges set out in the notice given by the Authority under paragraph 13.

13. Where, within 5 days of receipt by the Authority of the notice given by the licensee under paragraph 9, the Authority determines that charges proposed by the licensee would be likely to cause hardship to domestic customers, it may direct by notice in writing to the licensee that licensee's charges shall not exceed those which it specifies in the notice as being likely to avoid or mitigate such hardship.

14. The licensee shall not be required by paragraph 12(b) to make charges which are less than those which would be made under the licensee's deemed contract for comparable premises with similar metering arrangements supplied with electricity otherwise than in accordance with a last resort supply direction.

15. Unless the Authority otherwise consents, the licensee shall ensure that its terms and conditions (including charges) for a supply pursuant to a last resort supply direction do not show any undue preference or undue discrimination as between any persons or classes of persons.

16. Notwithstanding anything in standard condition 28 (Deemed Contracts), the terms of the licensee's deemed contract scheme for the supply of electricity to premises in accordance with a last resort supply direction may provide that, until the direction ceases to have effect, the customer may not terminate his deemed contract except –

- (a) with the consent of the licensee;
- (b) on taking a supply at the premises under a contract with the licensee or another electricity supplier; or
- (c) on ceasing to take electricity at the premises.

17. Where the licensee enters into any new contract for the purchase of electricity in order to comply with its obligations under this condition, it shall use reasonable endeavours to make the purchase as economically as possible in all the circumstances.

Condition 29A. Supplier of Last Resort Supply Payments

1. This condition sets out how, and how much, the licensee may recover in respect of any losses it incurs in complying with a last resort supply direction given under standard condition 29 (Supplier of Last Resort).
2. Except in relation to a claim made following a direction by the Authority pursuant to paragraph 13 of standard condition 29 (Supplier of Last Resort), paragraphs 3 to 12 of this condition shall not have effect in this licence in relation to any claim under sub-paragraph 3(a), sub-paragraph 3(b) or both those sub-paragraphs if before a last resort supply direction is issued to the licensee it gives notice of consent to that effect to the Authority.
3. Where the licensee intends to make a claim for the payment of monies ("last resort supply payments") pursuant to –
 - (a) standard condition 33 (Last Resort Supply: Security for Payment), as incorporated in the licence of the other supplier (as defined in paragraph 2 of standard condition 29 (Supplier of Last Resort));
 - (b) standard condition 48 (Last Resort Supply: Payment Claim) of the standard conditions of the electricity distribution licence,

the licensee shall in respect of each claim made notify the proposal to the Authority. The notification must include a calculation of the relevant amount with supporting information and must be received by the Authority within 6 months of the last resort supply direction to which it relates ceasing to have effect.
4. Subject to paragraphs 5 and 6, the total sum of last resort supply payments claimed by the licensee ("the relevant amount") shall not exceed the amount by which -
 - (a) the aggregate costs (including interest on working capital) reasonably incurred by the licensee in supplying electricity to premises in pursuance of the last resort supply direction, together with a reasonable profit,

are greater than

- (b) the aggregate amounts recovered by the licensee by way of charges for electricity supplied to premises in pursuance of the last resort supply direction (after taking all reasonable steps to recover such charges).
- 5. The Authority may, within 3 months of the notification under paragraph 3 and after consulting the licensee, determine that an amount other than that notified to it by the licensee is a more accurate calculation of the relevant amount.
- 6. Where the Authority makes a determination in pursuance of paragraph 5, the amount specified in the determination shall be treated as the relevant amount for the purposes of the following paragraphs of this condition.
- 7. In respect of a claim of the type mentioned in sub-paragraph 3(a), the licensee shall, within 6 months of the last resort supply direction to which it relates ceasing to have effect, submit the claim to the trustee appointed by the Authority pursuant to standard condition 33 (Last Resort Supply: Security for Payment) of the supply licence of the other supplier (as defined in paragraph 2 of standard condition 29 (Supplier of Last Resort)) specifying the relevant amount.
- 8. Where a last resort supply payment made to the licensee by the trustee referred to in paragraph 7 is less than the relevant amount, the licensee may claim from the relevant electricity distributors further last resort supply payments pursuant to paragraphs 9 and 10.
- 9. Last resort supply payments claimed by the licensee from the relevant electricity distributors shall not in aggregate exceed the amount by which the payment (if any) made to the licensee by the trustee referred to in paragraph 7 fell short of the relevant amount (the "under payment").
- 10. In respect of a claim of the type mentioned in sub-paragraph 3(b), the licensee shall, within 6 months of the last resort supply direction to which it relates ceasing to have

effect, submit the claim to each relevant electricity distributor (so far as is reasonably practicable all claims shall be submitted at the same time) specifying -

- (a) their respective proportion of the under payment (as defined in paragraph 9); and
- (b) whether payment is to be made by quarterly or monthly instalments.

11. The respective proportion shall be the same as the proportion of the total number of premises in Great Britain which is located within that relevant distributor's distribution services area.

12. In this condition "relevant distributor" means a distributor in whose licence Section C has effect.

Condition 29B. Provision for Termination upon a Direction

1. The licensee shall not enter into a contract for the supply of electricity to any premises whether or not the contract is for a specified period unless it provides that it shall terminate when a last resort supply direction given to an electricity supplier other than the licensee in pursuance of standard condition 29 (Supplier of Last Resort) of that other supplier's licence comes into effect in relation to the premises in question.
2. Where a domestic supply contract is for both the supply of electricity and the provision of other goods or services, any reference in this condition to its termination is a reference to its termination in respect of the supply of electricity alone.

Condition 33. Last Resort Supply: Security for Payments

1. The licensee shall establish and maintain arrangements ("security arrangements") in accordance with this condition.
2. If licensed to supply electricity to domestic customers, the licensee shall establish security arrangements by -
 - (a) taking out a bond or other instrument approved by the Authority; or
 - (b) making other arrangements as the Authority may approve,to secure such sum of money as is calculated in accordance with principles determined by the Authority and notified to the licensee but in any case not exceeding the maximum sum set out in paragraph 7.
3. The security arrangements established by the licensee shall provide that, in the event of the Authority giving directions to one or more other electricity suppliers under standard condition 29 (Supplier of Last Resort) as incorporated in those suppliers' licences to supply the licensee's domestic customers, there shall be payable, to such person as the Authority may appoint ("the trustee"), such sums, or instalments of sums, as the trustee may (after consulting the Authority) request, subject, however, to paragraphs 4 and 5.
4. The Authority may, at any time, vary the principles determined under paragraph 2 following consultation with the licensee, all other suppliers and the Consumer Council.
5. The licensee shall maintain the security arrangements and shall –
 - (a) ensure that the arrangements are not terminated or varied (save for the purpose of extending their duration or in accordance with sub-paragraph (b)) other than with the prior consent of the Authority; and

- (b) at least once in each year –
 - (i) consider whether the sum secured by the arrangements requires to be revised in order to ensure that it continues to be set in compliance with the principles determined by the Authority (as varied from time to time); and
 - (ii) where such sum requires revision, establish and thereafter maintain additional or amended arrangements with the approval of the Authority.
6. Where the Authority reasonably considers that the security arrangements established and maintained by the licensee do not secure a sum calculated in accordance with the principles determined by the Authority (as varied from time to time), it may at any time, issue a direction to the licensee requiring the licensee to establish and thereafter maintain additional or amended arrangements to secure such sums as may be specified in the direction.
7. Subject to paragraph 8, the maximum sum referred to in paragraph 2 shall be determined for each calendar year and shall be the aggregate of –
- (a) the product of the number, in that year, of domestic premises expected to be supplied and such sum, in respect of each premises, not exceeding £4, as may have been approved by the Authority-
 - (i) for that year, and
 - (ii) for the purposes of this condition generally,and have been so approved for the calendar year beginning on 1 January 2001, not later than 1 month after the date on which the Secretary of State determines these standard conditions pursuant to sub-section 33(1) of the Utilities Act 2000, and for any subsequent calendar year, not later than 30 September in the previous year, and
 - (b) the product of the amount of electricity expected to be supplied, expressed in kilowatt hours, and such sum per kilowatt hour, not exceeding 0.21p per kilowatt hour, as may have been approved by the Authority as aforesaid,

so, however, that if the Authority fails to approve, for the purposes of sub-paragraph (a) or (b) and as therein mentioned, an amount for any year, this paragraph shall have effect as if it had approved, for that year, the amount last so approved by it for a previous year.

8. In the application of paragraph 7, each of the maximum amounts specified in sub-paragraphs (a) and (b) (separately the “specified amount”) thereof shall be adjusted in accordance with paragraph 9 to produce the adjusted amount.
9. The adjusted amount referred to in paragraph 8 shall be the specified amount multiplied by x , where x is obtained by dividing the retail price index for the first month of the year beginning with an anniversary of [1 April 2001] by the retail price index for the month beginning with [1 April 2001]; and any reference in this paragraph to the retail price index is a reference to the general index of retail prices (for all items) published by the Office for National Statistics; and if that index is not published for any month that reference shall be read as a reference to any substituted index or index figure published by that office for that month.

Electricity – Distribution Licence

Condition 48. Last Resort Supply: Payment Claims

1. This condition sets out the circumstances in which the licensee shall increase its use of system charges in order to compensate any electricity supplier (a “claimant”) which claims for losses that it has incurred in complying with a last resort supply direction.
2. The following provisions apply where the licensee receives from a claimant a valid claim for a last resort supply payment.

3. For the purposes of this condition –

“last resort supply direction” and “last resort supply payment” have, respectively the meanings given to them in standard conditions 29 (Supplier of Last Resort) and 29A (Supplier of Last Resort Supply Payments) of the standard conditions of the electricity supply licence;

“price control condition” means any condition of the licence which places a monetary limitation on the use of system charges which may be levied or the use of system revenue which may be recovered by the licensee during a given period;

“relevant year” means, in relation to any valid claim -

(c) where the claim was received by the licensee at least 60 days before the beginning of a year, that year; or

(d) where the claim was received by the licensee less than 60 days before the beginning of a year, the next year;

“specified amount” means the amount specified on a valid claim together with interest calculated in accordance with paragraph 4;

“valid claim” means a claim for which a claimant has been give a consent by the Authority pursuant to standard condition 29A (Supplier of Last Resort Supply Payments) of the standard conditions of the electricity supply licence; and

“year” means a period of 12 months beginning with 1st April.

4. The interest referred to in paragraph 3 is simple interest for the period commencing with the date on which the valid claim was received by the licensee and ending with the date which is 61 days before the start of the relevant year, except where that period is of 30 days or less, in which case no interest shall be payable.
5. Where the licensee receives a valid claim it shall, during the relevant year, increase its use of system charges in respect of that year which relate to the distribution of electricity to premises to such an extent as it reasonably estimates to be appropriate to secure that the consequential increase in its revenue equals the specified amount.
6. The licensee shall, during, or as soon as practicable after the end of, the relevant year, pay to the claimant, by quarterly or monthly instalments (as specified in the claim), the amount of that consequential increase in revenue mentioned in paragraph 5 to the extent that it does not exceed the specified amount.
7. If the amount paid to the claimant under paragraph 6 is less than the specified amount, the licensee shall in the following year –
 - (a) pay to the claimant (in accordance with any directions given by the Authority) the shortfall together with 12 months’ interest thereon; and
 - (b) increase the charges which relate to the distribution of electricity to premises during the year following the relevant year to such extent as it reasonably estimates to be appropriate to secure that the consequential increase in its revenue equals the amount of that shortfall together with 12 months’ interest thereon.
8. If the amount of the consequential increase mentioned in paragraph 5 exceeds the specified amount, the licensee shall, during the year following the relevant year, decrease the charges which relate to the distribution of electricity to premises to the extent that it reasonably estimates to be necessary in order to

reduce its use of system revenue for that year by an amount equal to the excess together with 12 months' interest thereon.

9. Any question whether any estimate for the purposes of paragraph 5, 7 or 8 is a reasonable one shall be determined by the Authority.
10. The licensee shall not enter into any use of system agreement with an electricity supplier which does not permit variation of its use of system charges in pursuance of this condition.
11. The provisions of this condition shall have effect notwithstanding any of the provisions of standard condition 4 (Basis of Charges for Use of System and Connection to System: Requirements for Transparency).
12. In calculating the licensee's use of system revenue during any period for the purposes of a price control condition any increase or decrease in revenue attributable to the licensee's compliance with this condition shall be treated as if it had not occurred.
13. The licensee shall prepare, in respect of each year in which it increases or decreases charges in pursuance of paragraph 5, 7 or 8, a statement showing -
 - (a) the aggregate amount of its revenue derived from increases in charges in pursuance of paragraph 5;
 - (b) the aggregate amount of its revenue derived from increases in charges in pursuance of paragraph 7;
 - (c) the aggregate amount of the decrease in its revenue resulting from decreases in charges in pursuance of paragraph 8; and
 - (d) in the case of each last resort supply payment, the aggregate payments to the claimant made in respect of the year in question (whenever those payments were made).

14. The licensee shall give the statements referred to in paragraph 13 to the Authority within the first 4 months of the year following that to which they relate.
15. On giving the statement mentioned in paragraph 13(d) to the Authority, the licensee shall publish it in such manner as, in the reasonable opinion of the licensee, will secure adequate publicity for it.
16. Where the licensee receives more than one claim for a last resort payment, this condition (other than sub-paragraphs 13(a), (b) and (c)) shall apply separately as respects each separate claim but in so far as it results in changes to the licensee's use of system charges it shall have the cumulative effect of such separate applications.

Annex 2 – Deemed Contracts

General²³

- 1.1 When a customer uses gas otherwise than under a contract, a deemed contract comes into existence between the gas supplier and the customer. For example a deemed contract may exist when someone moves into a house and starts to use gas even though they have not agreed a contract with a gas supplier. A deemed contract will also exist when a supplier starts to supply gas or electricity as a SoLR.
- 1.2 The Utilities Act 2000 (when commenced) will require all electricity suppliers to have deemed contract schemes for all customer groups. These schemes will apply in a variety of circumstances, including when a supplier becomes a SoLR. In addition Schedule 6 to Electricity Act 1989 (as inserted by Schedule 4(3)(4) to the Utilities Act) will require the Authority to publish a document containing provision for determining the “appropriate supplier” for deemed contracts in certain cases.
- 1.3 In general, deemed contracts terms must not be unduly onerous. Subject to certain conditions, terms are considered to be unduly onerous if the revenue derived from supplying to customers:
 - ◆ significantly exceeds the costs incurred in supplying the customers; and
 - ◆ exceeds such costs by significantly more than the licensee’s revenue exceeds costs in the case of the generality of its domestic customers or in the case of the generality of its non-domestic customers (under the Utilities Act standard Licence Conditions, this clause applies except in each case when customers are supplied by a SoLR).
- 1.4 In addition, under the Utilities Act the supplier must use its reasonable endeavours to provide customers on deemed contract schemes with information about its other contractual terms.

²³ Standard Licence Condition 4 (current) and 28 (Utilities Act)

- 1.5 Neither of these conditions referred to in 1.3 or 1.4 applies if the supplier is supplying gas or electricity as a SoLR.
- 1.6 Deemed contract schemes may make different provision for different cases or classes of cases or for different areas. This means, for instance, that there can be different charges for domestic, Industrial and Commercial customers, prepayment meter customers and (electricity) Half Hourly customers. The charges can vary depending on which part of the country the customer is situated.

Gas

- 1.7 The Gas Act 1995 introduced a new schedule 2B into the Gas Act 1986 that provided for deemed contract in certain cases. A deemed contract scheme is compulsory in the domestic gas market (currently defined as annual consumption below 73,200 kWh). A gas supplier can elect to have a deemed contract scheme for annual consumption between 73,200 kWh and 2,196,000 kWh²⁴.

Electricity

- 1.8 Prior to 20 December 2000 there was no provision for deemed contracts in electricity. The Utilities Act 2000 (Commencement No 4 and Transitional Provisions) Order 2000 commenced (on a temporary basis) some of the deemed contract provisions in Schedule 4 to the Utilities Act as a new Schedule 6A to the Electricity Act 1989.
- 1.9 On 14 May 2001 the DTI made an amendment to Commencement Order No.4²⁵. One of the effects of the Order will be to alter the deemed contract provisions in Schedule 6A (which were commenced in December) in the following ways:
- ◆ electricity suppliers who are PESs, second-tier suppliers who also hold PES licences or are affiliates of PESs will have to prepare a deemed contract scheme to be used in the event that they start to supply a

²⁴ Gas Act 1986 Schedule 2B 8

²⁵ Utilities Act 2000 (Commencement Order No. 4 and Transitional Provisions)(Amendment) Order 2001

customer whose previous supplier has been served a Notice of Revocation of its licence;

- ◆ deemed contracts will be applicable from the date when a Notice of revocation is served on a supplier (rather than when the Notice comes into effect 30 days later); and
- ◆ outside a PES authorised area its associated second tier supply business and those companies that have purchased PES supply businesses will be able to supply on deemed contracts.

Annex 3 – Gas security cover guidance note

GUIDANCE NOTE FOR SECURITY TO BE PROVIDED **PURSUANT TO CONDITION 9(1) OF THE** **STANDARD CONDITIONS OF GAS SUPPLIERS' LICENCES**

Pursuant to the provisions of condition 9(1) of the Standard Conditions of Gas Suppliers' Licences, the Licensee is required to take out and maintain a bond or other instrument or make and maintain arrangements which in each case will be subject to approval by the Authority as providing adequate Security of payment for the purpose of that Condition, ("Security") under which certain sums will be payable to a trustee ("the Security Trustee") appointed by the Authority.

This document sets out guidelines on how to satisfy the provisions of Condition 9(1) and also how the Authority would propose to act in relation to the Security provided. In addition to the forms of Security described in this Guidance Note, the Authority will consider other arrangements proposed by a Licensee. Where those arrangements offer a lesser standard of Security than those described below, the Licensee may be asked to justify the proposed arrangements and make a case for the Authority to accept them.

1. FORM OF SECURITY

- 1.1. Set out below are four types of Security which a Licensee may provide and which in normal circumstances will satisfy the requirements of Condition 9(1) -

- 1.1.1. a first demand without proof or conditions performance bond from an insurance company (see paragraph 1.2)
- 1.1.2. an irrevocable confirmed standby letter of credit from a City of London branch of a bank (see paragraph 1.3)
- 1.1.3. a cash deposit (see paragraph 1.4)
- 1.1.4. a first demand without proof or conditions bond from the Licensee's ultimate holding company (see paragraph 1.5)

- 1.2. First demand without proof or conditions performance bond from an insurance company authorised under the Insurance Companies Act 1982 by the Department of Trade and Industry (an example format is set out in Schedule 1 to this Guidance Note);

For bonds less than £500,000 no further qualification is necessary, while for bonds between £500,001 and £1,000,000 the acceptable insurance company must have issued capital and reserves of at least £50,000,000. For bonds higher than £1,000,000 the Authority will wish to approve the insurance company on an individual basis.

- 1.3. An irrevocable standby confirmed letter of credit from a City of London branch of a bank that is a member of the British Bankers Association, payable in Sterling in London (an example format is set out in Schedule 2 to this Guidance Note).

For letters of credit of less than £500,000 no further qualification is necessary, while for letters of credit between £500,000 and £1,000,000 the acceptable bank must be UK regulated and domiciled. For letters of credit higher than £1,000,000 the Authority will wish to approve the bank on an individual basis.

- 1.4. A cash deposit of the sums specified in section 3 of this Guidance Note headed "Amount Secured", in Sterling in either -

- 1.4.1. a separately designated bank account at a branch of a bank which is a member of the British Bankers Association in the City of London, as notified by the Authority to the Licensee in the name of the Security Trustee; or
- 1.4.2. a separately designated bank account at the Licensee's bank (which is a member of the British Bankers Association) in the name of the Licensee with such account being charged in favour of the Security Trustee;

and in either case with such cash deposit bearing interest from the date of deposit of the principal sum to the date of its withdrawal for the account of the Licensee, but mandated for withdrawal of principal only against delivery of a Notice of Drawing as mentioned in section 4 of this Guidance Note headed "Conditions of Drawdown" (the "Escrow Account") provided that in either 1.4.1 or 1.4.2 above the specific details of the arrangements shall be as agreed between the Licensee and the Authority from time to time.

- 1.5. A first demand without proof or conditions bond from the ultimate holding company / companies of the Licensee (holding company as defined by section 736 of the Companies Act 1985, as amended by the Companies Act 1989) having a credit rating

of AA- (Standard and Poor's long-term rating) or Aa1 (Moody's long-term rating) or as shall otherwise be agreed by the Authority (an example format is set out in Schedule 3 to this Guidance Note).

- 1.6. If Security in the form of one of the types mentioned above is proposed by a Licensee, this would ordinarily satisfy the Authority that the requirements of Condition 9(1) would be fulfilled and the Licensee's proposal would be approved. However, in each particular case, the Authority will take into account all relevant circumstances, including the terms of the Security and the financial condition of the provider of the Security arrangements to those mentioned above, and the Authority may make additional enquiries into the suitability of the proposed Security and its provider.

2. VALIDITY

- 2.1. The first bond or letter of credit shall be valid, or the cash deposit shall remain in the Escrow Account, in each case until and including the date being six months after the end of the calendar year in which the Licensee is first licensed to supply gas to domestic customers, and shall require payment by the relevant, insurance company, bank or holding company against the Security Trustee's Notice of Drawing, if presented, from and including the date on which the Licensee is first so licensed to and until 6 months after the end of the first calendar year.
- 2.2. Thereafter, each subsequent bond or letter of credit or (as the case may be) Escrow Account cash deposit (in each case to be approved by the Authority for the purpose of Condition 9(1) to be renewed, replaced or substituted shall be renewed, replaced or substituted annually but in any event at least 10 days prior to the end of the calendar year and shall permit payment by the relevant insurance company or bank or holding company against the Security Trustee's Notice of Drawing presented from and including the first day of any calendar year to and including the date falling 6 months after the end of the relevant calendar year.
- 2.3. On a replacement or substituted Security coming into effect in accordance with paragraph 1.1.2, any unexplored existing Security will be released, as is provided in section 6 below.

3. AMOUNT SECURED

- 3.1. The amount secured should be calculated using the following formula and in accordance with condition 9:

$$\text{Average no. of premises} \times \text{£1} + \text{Average amount of gas} \times \text{£0.006}$$

4. CONDITIONS OF DRAWDOWN

- 4.1. The Security Trustee delivering whether by hand delivery, post, telex or facsimile transmission in a certificate ("Notice of Drawdown") in the form set out in Appendix II to Schedules 1,2 and 3 to this Guidance Note where the Security takes the form described in section 1.1.1, 1.1.2, or 1.1.4.

- 4.2. Any Notice of Drawing shall request that the monies be paid to the account of the Security Trustee at the bank specified in the Notice of Drawing. The Security Trustee may deliver as many Notices of Drawing under any particular Security as it sees fit.

5. SURPLUS

- 5.1. On completion by the Security Trustee of the administration of claims mentioned in condition 9(5) of the Licence made by a gas supplier or suppliers, the Security Trustee will repay to the provider of the Security upon whom a Notice of Drawing has been served, such part of the monies (including interest (if any)) paid by the provider to the Security Trustee as are not expended by the Security Trustee in making payment under the claims mentioned above and in discharging or reimbursing the Security Trustee's reasonable remuneration and expenses (as determined by or under his instrument of appointment).

6. RELEASE

- 6.1. Each bond or letter of credit shall be released, or (as the case may be) the principal amount (including any interest but less any costs, charges or expenses reasonably incurred by the Authority in operating the account) standing to the credit of the Escrow Account shall be paid to the Licensee, on and with effect from commencement of any replacement bond or letter of credit or Escrow Account cash deposit (in each case approved by the Authority for the purposes of condition 9(1)).

7. CHANGE OF RATING

- 7.1. If any insurance company being the issuer of a bond shall cease to be authorised to do insurance business of a class which includes the provision of such a bond under the Insurance Companies Act 1982, or a bank being the issuer of a letter of credit shall cease to be a member of the British Bankers Association, or the rating of the ultimate holding company / companies of the Licensee falls below that referred to in paragraph 1.5, the Authority will, upon becoming aware of the same, re-assess the Security. Following the re-assessment, the Authority may determine that the Security provided remains adequate or, alternatively, that the Security is no longer adequate and its approval by the Authority may be withdrawn in accordance with condition 9(2). In such circumstances, the Licensee will be obliged to take out a replacement Security approved by the Authority for the purposes of condition 9(1).

SCHEDULE 1

To: The Authority
Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

Date: []

Dear Sirs

FIRST DEMAND WITHOUT PROOF OR CONDITIONS BOND

BENEFICIARIES: The Authority and any Trustee appointed under Condition 9 of the Standard Conditions of Gas Suppliers' Licences

1. Upon the application of [] with its registered office at [] we hereby issue this irrevocable First Demand Without Proof or Conditions Bond in favour of the Beneficiaries for an amount of £[] ([]) Pounds Sterling.
2. All definitions used within this Bond are as defined Appendix I.
3. Following presentation to us on or before the Expiry Date at the Place of Drawdown of a Notice of Drawing, we shall no later than the Payment Time pay to the Trustee the amount demanded, as required by the Notice of Drawing. A Notice of Drawing may be presented by the Authority or by the Trustee.
4. This Bond shall be effective from the Effective Date and shall expire at 5 o'clock London time in the afternoon on the Expiry Date.
5. Partial drawing is allowed and more than one Notice of Drawing may be presented, so long as the total amount demanded pursuant to all Notices of Drawing does not exceed £[] ([]) Pounds Sterling).
6. This Bond is a separate transaction from any contract by virtue of which it may be given and we are in no way concerned with, or bound by, such contract. Our duty and liability under this Bond is to pay the sum or sums herein stated without any set-off or counter-claim or other withholding on presentation of each Notice of Drawing by the Payment Time notwithstanding the terms of any such contract, any amendment thereof, any dispute in connection therewith, or any other matter.
7. This Bond is governed by and shall be construed in accordance with the laws of England and the courts of England shall have jurisdiction to settle any disputes which may arise out of it and we irrevocably submit to the jurisdiction of such courts. However, nothing herein shall limit your right to take proceedings against us in connection with this Bond in any other court of competent jurisdiction or to take such proceedings in one or more jurisdictions, whether concurrently or not.

Yours faithfully

.....
for and on behalf of
[]

APPENDIX I

DEFINITIONS

“Beneficiaries”	The Authority and any Trustee
“Business Day”	a day on which banks are open for business in the City of London
“Effective Date”	[] 20[]
“Expiry Date”	[30 June 20[]]
“Place of Drawdown”	our office at [] or if we are no longer at that office as then appears from the [Companies Registry]
“Notice of Drawing”	a notice of drawing under this Bond substantially in the form set out in Appendix II hereto
“Payment Time”	the end of the Business Day next following the Business Day on which a Notice of Drawing is presented at the Place of Drawdown
“Trustee”	any trustee appointed by the Authority under Condition 9 of the Standard Conditions of Gas Suppliers’ Licences

APPENDIX II

To:

Date: []

Dear Sirs

FIRST DEMAND WITHOUT PROOF OR CONDITIONS BOND

Date of Issue: []

("The Security")

.....

We refer to the above Security. We hereby demand immediate payment thereunder in the amount of £[] We require payments to be made in cleared funds to:

[] Bank plc
Address: []
Sort Code: []
Account Name: []
Account Number:[]

Yours faithfully

for and on behalf of the Authority

.....
Duly authorised officer

for and on behalf of [Security Trustee]

.....
Duly authorised officer

SCHEDULE 2

To: The Authority
Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

Date: []

Dear Sirs

IRREVOCABLE STANDBY LETTER OF CREDIT NO. []

BENEFICIARIES: The Authority and any Trustee appointed under Condition 9 of the Standard Conditions of Gas Suppliers' Licences

1. Upon the application of [] with its registered office at [], we hereby issue this irrevocable Standby Letter of Credit in favour of the Beneficiaries for an amount of £[] ([] Pounds Sterling).
2. All definitions used within this Standby Letter of Credit are as defined in Appendix I.
3. Following presentation to us on or before the Expiry Date at the Place of Drawdown of a Notice of Drawing, we shall no later than the Payment Time pay to the Trustee the amount demanded, as required by the Notice of Drawing. A Notice of Drawing may be presented by the Authority or by the Trustee.
4. This Standby Letter of Credit shall be effective from the Effective Date and shall expire at 5 o'clock London time in the afternoon on the Expiry Date.
5. Partial drawing is allowed and more than one Notice of Drawing may be presented, so long as the total amount demanded pursuant to all Notices of Drawing does not exceed £[] ([] Pounds Sterling).
6. This Standby Letter of Credit is subject to the Uniform Customs and Practice for Documentary Credits (1993 Revision, International Chamber of Commerce, Paris, France, Publication No. 500) insofar as the same are applicable and engages us in accordance with the terms thereof.
7. This Standby Letter of Credit is governed by and shall be construed in accordance with the laws of England and the courts of England shall have jurisdiction to settle any disputes that may arise out of it and we irrevocably submit to the jurisdiction of such courts. However, nothing herein shall limit your right to take proceedings against us in connection with this Standby Letter of Credit in any other court of competent jurisdiction or to take such proceedings in one or more jurisdictions, whether concurrently or not.

[Yours faithfully

.....
for and on behalf of [Bank]]

APPENDIX I

DEFINITIONS

“Beneficiaries”	The Authority and any Trustee
“Business Day”	a day on which banks are open for business in the City of London
“Effective Date”	[] 20[]
“Expiry Date”	[30 June 20[]]
“Place of Drawdown”	the Bank’s office at [] or if we are no longer at that office, our registered office as then appears from the [Companies Registry]
“Notice of Drawing”	a notice of drawing under this Letter of Credit substantially in the form set out in Appendix II hereto
“Payment Time”	the end of the Business Day next following the Business Day on which a Notice of Drawing is presented at the Place of Drawdown
“Trustee”	any Trustee appointed by the Authority under Condition 9 of the Standard Conditions of Gas Suppliers’ Licences

APPENDIX II

To:

Date: []

Dear Sirs

STANDBY LETTER OF CREDIT NO. []

Date of Issue: []

("The Security")

.....

We refer to the above Security. We hereby demand immediate payment thereunder in the amount of £[] We require payments to be made in cleared funds to:

[] Bank plc
Address: []
Sort Code: []
Account Name: []
Account Number:[]

Yours faithfully

for and on behalf of the Authority

.....
Duly authorised officer

for and on behalf of [Security Trustee]

.....
Duly authorised officer

SCHEDULE 3

To: The Authority
Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

Date: []

Dear Sirs

FIRST DEMAND WITHOUT PROOF OR CONDITIONS BOND

BENEFICIARIES: The Authority and any Trustee appointed under Condition 9 of the Standard Conditions of Gas Suppliers' Licences

1. Upon the application of [] with its registered office at [] we hereby issue this irrevocable First Demand Without Proof or Conditions Bond in favour of the beneficiaries for an amount of £[] ([]) Pounds Sterling.
2. All definitions used within this Bond are as defined Appendix I.
3. Following presentation to us on or before the Expiry Date at the Place of Drawdown of a Notice of Drawing, we shall no later than the Payment Time pay to the Trustee the amount demanded, as required by the Notice of Drawing. A Notice of Drawing may be presented by the Authority or by the Trustee.
4. This Bond shall be effective from the Effective Date and shall expire at 5 o'clock London time in the afternoon on the Expiry Date.
5. Partial drawing is allowed and more than one Notice of Drawing may be presented, so long as the total amount demanded pursuant to all Notices of Drawing does not exceed £[] ([]) Pounds Sterling).
6. This Bond is a separate transaction from any contract by virtue of which it may be given and we are in no way concerned with, or bound by, such contract. Our duty and liability under this Bond is to pay the sum or sums herein stated without any set-off or counter-claim or other withholding on presentation of each Notice of Drawing by the Payment Time notwithstanding the terms of any such contract, any amendment thereof, any dispute in connection therewith, or any other matter.
7. This Bond is governed by and shall be construed in accordance with the laws of England and the courts of England shall have jurisdiction to settle any disputes which may arise out of it and we irrevocably submit to the jurisdiction of such courts. However, nothing herein shall limit your right to take proceedings against us in connection with this Bond in any other court of competent jurisdiction or to take such proceedings in one or more jurisdictions, whether concurrently or not.

Yours faithfully

.....
for and on behalf of
[Holding Company]
[]

APPENDIX I

DEFINITIONS

“Beneficiaries”	The Authority and any Trustee
“Business Day”	a day on which banks are open for business in the City of London
“Effective Date”	[] 20[]
“Expiry Date”	[30 June 20[]]
“Place of Drawdown”	our office at [] or if we are no longer at that office as then appears from the [Companies Registry]
“Notice of Drawing”	a notice of drawing under this Bond substantially in the form set out in Appendix II hereto
“Payment Time”	the end of the Business Day next following the Business Day on which a Notice of Drawing is presented at the Place of Drawdown
“Trustee”	any Trustee appointed by the Authority under Condition 9 of the Standard Conditions of Gas Suppliers’ Licences

APPENDIX II

To:

Date: []

Dear Sirs

FIRST DEMAND WITHOUT PROOF OR CONDITIONS BOND

Date of Issue: []

("The Security")

.....

We refer to the above Security. We hereby demand immediate payment thereunder in the amount of £[] We require payments to be made in cleared funds to:

[] Bank plc
Address: []
Sort Code: []
Account Name: []
Account Number:[]

Yours faithfully

for and on behalf of the Authority

.....
Duly authorised officer

for and on behalf of [Security Trustee]*

.....
Duly authorised officer