DTI Consultation on Proposals for a Special Administrator Regime for Energy Network Companies

Ofgem's Response

June 2003

Introduction

Ofgem welcomes the DTI consultation on proposals for a special administrator regime for the energy sector as it has been concerned for some time that there are no provisions within the Gas or Electricity Acts to ensure that, in the event of a major energy network company (ENC) becoming insolvent, that network business would continue to operate.

In the past, the possibility of a monopoly network operator becoming insolvent has been regarded as remote. It is much less clear that this remains the case today, in spite of the introduction of financial ring-fencing conditions. The growing trends of combining network businesses with other, more risky activities in the same corporate group, and of highly leveraged financing structures, increase the risk of financial failure. Moreover, the consequences of failure would be severe if the company was not able immediately to continue to trade. Security of supply and public safety would be immediately and progressively threatened.

The Water Industry Act and the Railways Act both contain specific provisions that vary the applicable insolvency law. While in both industries the Insolvency Act may apply and a receiver or administrator be appointed under it, the relevant regulator and the Secretary of State may alternatively petition the Court for appointment of a Special Administrator. The Special Administrator is charged with making a scheme for the transfer of the licensee's assets and undertaking to a new licensee appointed by the regulator or Secretary of State and, in the interim, ensuring that the licensee continues to trade. These duties contrast with those of a receiver or administrator appointed under the Insolvency Act who would simply be obliged to obtain the best possible price for the assets of the licensee. The Water Industry and Railways Acts also empower the relevant Secretary of State to make available finance from funds voted by Parliament for the purpose of enabling a licensee in special administration to continue to trade.

Similar provisions apply to National Air Traffic Control (NATS) and the PPP arrangements for London Underground.

There are no equivalent provisions in the Gas or Electricity Acts. At present, the general insolvency law would apply to network licensees without variation. Ofgem has consistently argued that this represents a flaw in the regulatory framework governing the gas and electricity transportation industries.

Provisions to enable the appointment of a special administrator in the event of a failure of a network business were originally to have formed part of the Utilities Bill and were subsequently proposed by Lord Borrie in an amendment to the Enterprise Bill. In responding to that amendment the government agreed to consult on the issue as they are now doing. It is important that the opportunity is now taken to put these provisions in place.

Funding

A key aspect of the proposed arrangements relates to how they will be funded and it will be important to change the approach to these matters envisaged in the April consultation.

ENCs have relatively predictable cash flows. Revenues arise from connection and use of system charges that are capped by regulation. Operating costs can also be predicted with a high degree of certainty, and are in any event largely within the control of management. The price controls are set so as to enable an efficiently managed company to recover ordinary operating costs from revenues on a pay-as-you-go basis.

It is to be expected that a company facing insolvency, or that has become insolvent, as a result of facing higher incurred or future costs than allowed under its price control, would seek to persuade Ofgem to re-open its price control, with a view to averting insolvency and/or to increase the value of its business so as to improve recovery for creditors.

Ofgem would be duty bound to consider any such application in the light of all relevant facts and circumstances and its statutory duties. In particular Ofgem has a duty to have regard to the ability of the companies to finance their obligations under the Gas and Electricity Acts. In cases where there is some genuine and unforeseeable reason for the costs to have increased materially beyond what was assumed in the price control review then Ofgem could be expected to reflect that in changes to the price control – and in that case the customers of the company concerned would bear the costs.

However, it cannot be assumed that Ofgem would increase price control revenues in any particular case. In particular, it is unlikely that increases in allowable revenues would be allowed to enable recovery of additional costs that could be mitigated or

avoided by prudent and efficient management action and/or that do not arise from an external development.

A failure to control costs could therefore result in insolvency, as operating margins might be squeezed to such an extent as to leave insufficient cover for interest charges and dividends, damaging investor confidence and causing the company to breach the terms of its financial facilities. In such circumstances, it would be likely to lose all access to sources of liquidity.

In this respect, the case of an ENC would be no different from that of any participant in any other sector of the economy. In the latter case, creditors and/or members would bear the loss. To this extent, there would, therefore, be no justification for consumers to bear excess costs in the case of an ENC. The costs should be borne by the creditors and/or members.

In considering the question of funding it is important to distinguish between the question of who ultimately bears the costs and the need of the administrator for an immediate source of cash or a guarantee in order to allow the company to continue operating.

In particular, there may be a need for temporary funding to be provided to the extent cash costs exceed revenues generated from operation. In any event, the administrator would require assurance that his own costs will be met. Accordingly, there will be a clear need for a guarantee to be provided to the administrator covering whatever commitments and costs he incurs in that capacity. Whether such a guarantee will require to be funded in any particular case may only become apparent as the administration progresses. Although in some cases there may be an immediate need for funds, in others no need may arise at any time.

As provider of such guarantee, a standing fund is not ideal. To be able to give an unlimited guarantee acceptable to an administrator, the fund would need to be reasonably large, and be backed by an unconditional power to raise whatever further requirements might arise. Establishment, financing and administration of such a fund would carry significant costs which would be borne by consumers. In particular, the opportunity cost of the idle money would be a 'deadweight' cost, increasing the retail price of energy without compensating benefits.

The most appropriate source for such contingency funding is the Exchequer. Clearly the government should not ultimately bear the cost of administration and hence any funding provided would need to be on the basis of a loan secured by a first priority right to recovery from the proceeds of sale or refinancing of the insolvent ENC. The government would then be repaid from the sale of the assets or through the re-financing so that ultimately the cost of administration would be born by the creditors and members of the company.

Given the nature of the ENCs it seems reasonable to assume that there would always be adequate funds from the sale or refinancing of the company to repay this loan, although this is perhaps less certain in the case of independent gas transporters. However it may be prudent to establish the facility for an industry levy to be raised in the event that insufficient funds were available from these sources.

It is acknowledged that the costs of special administration may be slightly higher than the costs of ordinary administration and there may be some additional costs associated with keeping the business running. An argument could therefore be made for the creditors of the company only bearing an amount equivalent to the costs of ordinary administration with the excess being picked up by customers through either an increase in future charges for use of the failed ENC's network (which would effectively concentrate the excess costs on those consumers connected to it) or an industry-wide levy to spread the costs across all consumers. However the difference is unlikely to be significant and would in practice be very hard to determine. On this basis the approach outlined above seems a pragmatic and not unreasonable way forward.

Comments on specific questions raised

How effective special administration would be in contributing to continuity of supply during the administration and thereafter

A special administration regime should ensure security of supply in the unlikely event of an ENC becoming insolvent, provided that, in case of need, funding is made available, as discussed above.

While it might be considered relatively unlikely that, in the absence of the specific duty of a special administrator to continue to provide service to consumers, an administrator would deliberately de-energise connected consumers (though this is not impossible), it is

altogether more likely that he would not incur the expense needed to reconnect consumers in the event of supply interruptions, replace failed assets or (especially) provide new connections or reinforce the network to accommodate increased flows, as the expense might well in these cases exceed the marginal revenue earned. There is doubt how far the Authority would in these circumstances be able successfully to enforce licence duties against the administrator of an insolvent ENC.

Whether legislating for such a regime would be proportionate to the risk and consequences of networks ceasing to operate as a result of normal insolvency procedures

There do not appear to be any significant costs associated with introducing such a regime – in particular if the requirement for funding is reconsidered as set out above. As indicated in the RIA the costs to society could be huge were there to be an interruption to supply. On the gas network these could include risks to public safety. While the chances of a company becoming insolvent are small they are not negligible. In those circumstances it would seem proportionate to legislate for such an eventuality.

In addition, lack of any special administration arrangement may lead companies or their lenders to perceive that Ofgem's duties to protect consumers' interests will create an extreme reluctance on the part of Ofgem to allow a network licensee to become insolvent, even to the extent of relaxing price controls to avoid this outcome. Such a perception of reduced downside risk – whether or not Ofgem would in practice respond in this way – could lead companies to take greater risks with quality and security of supply (on the basis that they will benefit from the upside but that downside risk will be transferred to customers). This perception of risk transfer would be distorting incentives in a way which is clearly undesirable and could increase the risk of security of supply problems, irrespective of whether insolvency ever actually occurred.

Under what circumstances, and by whom, it would be reasonable to seek the appointment of a special administrator

It should be possible for the Authority with the consent of the Secretary of State (or the Secretary of State alone) to seek the appointment of a special administrator where the company is or is likely to be unable to pay its debts, consistent with the provisions in other sectors. The RIA (at paragraph 9.1) suggests that it would only be the government that could seek the appointment of a special administrator. As the sectoral regulator,

Ofgem should also have this power, albeit only to be exercised with the agreement of the Secretary of State.

In addition there are potential issues in relation to managing the transfer of a company's assets in the circumstances where their licence is revoked other than by reason of insolvency, which require similar treatment to the provisions for special administration. It would be helpful to have, as the Water Industry Act does, a provision for transfer schemes to be made and approved by the Secretary of State to achieve such a transfer. However, Ofgem recognises that there may be industry concerns with covering this scenario through the special administration regime.

Ofgem does not consider that it would be appropriate for licence breach to be a trigger for special administration as it is in water, as this could lead to a disproportionate increase in regulatory risk.

Whether the Regulator or Secretary of State should have the right to approve (or veto) the transfer of the undertaking

The special administration provisions of the Water Industry and Railways Acts require transfer schemes to be approved by the Secretary of State in order to become effective. The Secretary of State also has power to modify any scheme before approving it. These powers are tantamount to a power of veto. Ofgem considers similar provisions would be appropriate in relation to ENCs. In addition, in determining whether to approve a transfer scheme, with or without modification, the Secretary of State should be required to consult Ofgem and have regard to its advice.

Whether express provision is needed in advance to secure the funding of special administration, for example through creating an industry fund, contributed to by licensed network operators and suppliers

It would be inappropriate to create an industry fund which would be contributed to in advance to secure the funding for special administration for the reasons set out above.

Whether alternatively or in addition there are safeguards that could be introduced which could reduce the possibility of a network operator entering an insolvency procedure

Ofgem has put in place a number of safeguards designed to allow companies continuing access to finance to fund investment programmes and reduce the possibility of a network operator entering insolvency. The energy network companies' licences already contain ring-fencing conditions which are aimed at protecting the regulated business against financial pressures arising elsewhere in the group and at ensuring that the financial resources of the regulated business are not exposed to inappropriate risks nor diverted to other purposes. It might be possible to put in place additional measure to safeguard the regulated business in the event that its own actions gave rise to financial difficulty, but this would have the effect of undermining the power of the incentive framework which has proved so successful in reducing costs to consumers without compromising security and quality of supply. It would therefore be inappropriate. Accordingly, special administration is the most appropriate safeguard to put in place to ensure continuity of supply in the event of insolvency while maintaining and (as discussed above) strengthening the incentive framework.

Whether there are alternatives to a special administration scheme that would provide similar or greater protection in terms of ensuring continuity of supply in the event of the insolvency of a network operator, but better address a wider range of concerns

Ofgem has not been able to identify any alternatives to special administration.

The Energy Act 1976 empowers the Secretary of State, where an Order in council is made on the grounds that there is in the UK an actual or threatened emergency affecting fuel or electricity supplies, to make orders regulating or prohibiting the supply of electricity and to direct any electricity supplier to supply electricity to specified persons in accordance with specified requirements. Failure to comply with such an order without reasonable excuse constitutes an offence.

While the Energy Act powers are extensive, it is unclear how far these powers might be used to ensure than an insolvent ENC continued to operate its network so as to enable supplies to be made to consumers. In particular, it is unclear whether (1) the insolvency of an ENC would be held to be an 'emergency affecting fuel or electricity supplies'; (2)

an ENC would be held to be a 'supplier' for the purposes of the Act, (3) insolvency, or a lack of funding with which to discharge the costs of making a supply, would be held to be a 'reasonable excuse', and (4) the powers could be exercised in such a way as to bring about a durable solution to the insolvency situation.

The impact that introducing such legislative provisions might have on the commercial funding of networks more widely and on the financing of the sector as a whole

It is for industry and the City to comment in detail on the impact that these provisions would have on commercial funding. However it appears that water companies who have had these provisions in place for some time have not encountered any difficulty in obtaining funding nor is there any indication that their cost of capital is higher as a result. It seems reasonable to expect that the certainty that would be offered through having a clear legislative provision for such eventualities (given it is clear that government could not stand by and let widespread interruptions take place) would be appreciated by investors.

Moreover, the Water Industry and Railways Acts provisions ensure that a special administrator in drawing up a transfer scheme must have regard to the interests of all creditors and members of the insolvent entity. It is at least arguable that this provides greater protections for these groups than do the Insolvency Act and Enterprise Act provisions. To this extent, providers of finance might be expected to welcome them.

Other comments

The main consultation makes clear that this provision would apply to all gas transporters. However, the RIA while listing all other categories of network operator does not make specific reference to independent gas transporters. Ofgem's understanding from the DTI is that it is envisaged these would fall within the scope – and supports that position.

The RIA says the proposals would "effectively preclude" the possibility that the other forms of insolvency procedure might be employed. Ofgem's understanding of the proposal is that while the Secretary of State would have the opportunity to invoke Special Administration in place of other forms of insolvency procedure she would not actually be required to do so.

Conclusion

Ofgem strongly supports the DTI proposal for a special administrator regime for energy network companies but considers that the option of creating an industry fund, in advance, to fund the costs of the scheme would increase costs to consumers unnecessarily. Instead, it recommends provision be made on a basis similar to the Water Industry and Railways Acts for the Secretary of State to provide financial support out of funds voted by Parliament. If there is considered to be sufficient doubt that any support extended could be recovered from the proceeds of sale or refinancing of the insolvent ENC, a reserve power to levy industry members would be more appropriate than a fund.