

Arrangements for responding in the event that a network company experiences deteriorating financial health

Document Type: Position paper

Ref: 158/08

Date of Publication: 4 December 2008

Target Audience: All network licensees. Network company investors, debt holders and equity analysts. All other interested parties.

Overview:

This document sets out in high level terms the arrangements that are currently in place to protect customers in the event of an energy network company experiencing deteriorating financial health and/or financial failure. We also set out our intention to review, test and, if necessary, enhance these arrangements to ensure that they remain fit for purpose.

We have long had in place what we consider to be robust arrangements for dealing with network company financial distress. The companies understand these arrangements. However we think it is important given current conditions in the capital markets and in light of our better regulation duties to develop, test and publish a procedural manual for guidance purposes setting out the arrangements we have in place for dealing with financial distress. This document has not been prompted by concerns about any particular network company.

Contact name and details: Hannah Nixon, Director, Regulatory Review

Tel: 020 7901 7165

Email: hannah.nixon@ofgem.gov.uk

Team: Regulatory Review

Context

Should the financial position of a network company deteriorate, that company may struggle to continue to invest appropriately to maintain and develop its network and deliver acceptable network and customer service performance. It may not, for example, be able to meet demands for new connections. If those conditions prevail over time then customers may receive less reliable network performance and service, which could ultimately threaten the security and reliability of their energy supplies.

Protecting the interests of current (and future) consumers is our primary statutory duty. The legislative and regulatory framework in place for Britain's energy networks is designed to reduce the risk of financial distress affecting network operators and to ensure that an acceptable level of service continues to be provided to consumers should financial distress occur. It is also designed to prevent companies damaging the long-term health of the networks by cutting back inappropriately on capital expenditure.

Our Corporate Strategy sets out our duty to help ensure that Britain's energy consumers are shielded as far as possible from the harshest effects of growing global influences on the British market¹. The prevailing economic conditions, in particular recent events in the capital markets, could increase the financial pressure on some energy network companies. Although there have been a number of significant company failures in the energy sector (for example Enron, TXU and British Energy), no network company has faced a period of significant financial distress² or been declared insolvent since privatisation. The arrangements for dealing with a network company in these circumstances are therefore untested. This contrasts with generation, gas production, shipping and energy supply where there have been company failures and the arrangements have been tested and found to be broadly satisfactory. Given the increased risk associated with the current economic conditions, we think it is important to test and review the existing arrangements for monitoring and responding to financial distress of a network company to make sure these are as robust as possible.

Associated documents

- Supplier of last resort: revised guidance – Ofgem, September 2003
http://www.ofgem.gov.uk/Licensing/Work/Revoc/Documents1/5174-SolR_guidance_doc_24nov03.pdf

<http://www.ofgem.gov.uk/Licensing/Work/Revoc/Pages/Revoc.aspx>

¹ Corporate Strategy and Plan 2008-2013: Decision document - Ofgem, 31 March 2008 #34/08.
<http://www.ofgem.gov.uk/About%20us/CorpPlan/Documents1/CORPORATE%20STRATEGY%20AND%20PLAN%2028%20MARCH%202008.pdf>

² Aquila Energy Networks plc did experience some financial difficulties but these were addressed overtime.

Table of Contents

Summary	1
1. Introduction and background	3
Purpose of this document	3
Ofgem’s duties	4
Definition of financial distress	4
Indicators of financial distress	5
Scope for financial distress	5
Special administration	5
2. Existing arrangements	7
Ring fencing provisions and associated monitoring arrangements	7
Enforcement actions	8
Overall position on Ring Fencing, Monitoring Arrangements & Enforcement	9
Reopening a price control	9
Special administration regime	12
Overall position	13
3. Reviewing the existing arrangements	14
Monitoring arrangements.....	14
Procedural manual	14
Testing the arrangements – simulation exercise	15
4. Next steps and timetable	16
External engagement	16
Appendices	17
Appendix 1 – Legal framework	18
Principal objective and general duties.....	18
Provision of information to the Authority.....	19
Financial ring-fence.....	20
Insolvency Act 1986	22
Energy Act 2004.....	22
Appendix 2 – The Authority’s Powers and Duties	24
Appendix 3 - Glossary	26

Summary

Ofgem's principal duty is to protect the interests of present and future consumers. In the absence of mitigating measures, the implications of a network company experiencing financial distress and struggling to maintain and develop its network may be to impact consumers through a reduction in service and/or reduced security or quality of supply.

We consider that we have robust arrangements in place to minimise the risks to and impact of deteriorating financial health of a network company on consumers. These arrangements are well understood by network companies and include:

- procedures for collecting and monitoring network data;
- financial ring-fencing conditions which place constraints on the operation of network companies;
- provisions for reopening/disapplying price controls; and
- the ability, with the consent of the Secretary of State, to apply to the Court to place a 'protected energy company' into special administration.

The regulatory framework provides strong financial incentives on network companies to strive for greater efficiency whilst still meeting the terms of their regulatory settlements and their legal duties and obligations relating to providing reliable, secure and safe networks. The disciplines provided by the capital markets, including the threat of bankruptcy, are important in underpinning these incentives. They also encourage companies to innovate financially and to take appropriate risks.

We consider that retaining these incentives on network companies is essential to maintaining value for money for customers. It is not, therefore, our aim to prevent the financial failure of a network company or to bail out a company that has encountered financial difficulties as a result of its own actions (or inaction), for example because of an inappropriate financial structure or poor management. The primary responsibility for the financial integrity of a network company lies firmly with that company's management and shareholders.

Ofgem has a legal duty to make sure that efficient, well managed network companies can finance their costs. If financial distress arises despite the company operating in an economic and efficient manner, there are powers available to the Authority, exercisable at its discretion, to seek to remedy the situation. These include the ability for companies to seek the re-opening of an existing price control.

While we consider our existing arrangements for addressing financial distress to be robust, they have not been tested to date. We therefore consider it is important to test the robustness of our existing arrangements to ensure that consumers do not face any undue risks associated with financial failure or distress. This is particularly the case given prevailing economic conditions. In addition, in the interests of better regulation, in particular transparency, we propose to develop and publish a

procedural manual for guidance purposes setting out the arrangements we have in place to respond to the deteriorating financial health of a network company.

We intend to publish the draft procedural manual in the first quarter of 2009 for consultation. Simultaneously, we intend to run a simulation exercise to test the arrangements. Our procedural manual will then be published in early spring 2009.

We are mindful that any case of network company financial distress or failure that occurs will likely turn on its own particular facts. As such, neither this document which provides a high level summary of the arrangements currently in place nor the procedural manual that we propose to publish in 2009 for guidance purposes, are intended to fetter the scope of the Authority's powers or the exercise of its discretion whether under licence, statute or otherwise. Equally, neither document is intended to create any legitimate expectation that specific cases will be dealt with in a particular manner.

1. Introduction and background

Chapter Summary

This chapter sets out the purpose of this document. It discusses the concepts relevant to financial distress and sets out the background to the special administration regime.

Purpose of this document

1.1. The purpose of this document is two-fold:

- to set-out the existing arrangements we have in place to protect consumers from the effects of the financial failure of network companies; and
- to outline our intention to review, test and, if necessary, enhance these arrangements to ensure they remain fit for purpose.

This work is aimed at ensuring that the arrangements we have in place are well understood by stakeholders and are as robust as possible. It is not driven by concerns about a specific company or companies.

1.2. The principal aim of the review is to ensure that the risks to and impact on consumers associated with the financial failure of a network company are minimised. Ultimately, responsibility for the financial integrity of network companies should, and does, rest with the management of those companies and their shareholders.

1.3. The intention of reviewing the existing arrangements is not therefore to eliminate the possibility of financial failure of a network company. The disciplines provided by the capital markets, including the threat of bankruptcy, are important in providing incentives for network companies to strive for greater efficiency whilst meeting the terms of their regulatory settlements. Further they encourage companies to innovate financially and to take appropriate risks. An example of this is the rationalisation of network company balance sheets since privatisation.

1.4. This document is concerned with cases where network companies, to whom the special administration arrangements apply, face financial distress. Network companies include owners of gas and electricity transmission and distribution networks (including independent network operators). In the future they may also apply to owners of offshore electricity transmission networks (OFTOs), however, there are potentially other arrangements that may apply to such parties including 'OFTO of Last Resort' provisions that were considered in the recent joint Ofgem/DECC consultation document³ on the future regulatory arrangements for OFTOs. This document does not consider issues associated with the financial health

³ Offshore electricity transmission: A further joint Ofgem/DECC regulatory policy update – consultation, DECC/Ofgem – 20 November 2008 <http://www.berr.gov.uk/files/file49061.pdf>

of gas and electricity supply companies. Ofgem has in place separate arrangements in the event of the failure of a gas or electricity supplier or a gas shipper. Those are referred to as the Supplier of Last Resort arrangements.

Ofgem's duties

1.5. Ofgem's principal duty is to protect the interests of consumers⁴. The implications of a network company experiencing financial distress may directly impact consumers. In addition, Ofgem has a duty to secure that licensees are able to finance their obligations under the Gas Act and Electricity Act. This does not mean Ofgem would provide regulatory relief to alleviate financial distress in all circumstances. We would consider why a licensee faced financial distress and to what extent they had financed and operated the relevant network efficiently. Network licensees have an obligation to develop and maintain efficient and co-ordinated systems. Where financial distress arises despite the company operating in an economic and efficient manner, Ofgem would consider at its discretion what tools, if any, are appropriate to respond to that distress.

1.6. Appendix 1 sets out an overview of the relevant legal framework.

Definition of financial distress

1.7. Financial distress describes a situation where an affected party cannot access the financial resources required to discharge its obligations. In the case of a network company, this means that they may struggle to finance their licensed activities.

1.8. There are a number of potential causes of financial distress. In some cases financial distress may reflect the actions or strategies of the affected company, such as the failure of management to control expenditure or excessive gearing, where a company relies heavily on debt to finance its activities. It can also result from the actions of another party, such as the default or insolvency of a major trading partner. Finally, financial distress may result from the impact of exogenous factors that impose additional costs on a company or make it less attractive to investment. Financial distress may result from a combination of these or other factors.

⁴ The Energy Bill received Royal Assent on Wednesday 26 November 2008. The new Energy Act 2008 (the "2008 Act") contains provisions which will modify the general duties of the Authority under the Gas Act 1986 and the Electricity Act 1989. Specifically, those provisions, when commenced, will change the current hierarchy of duties under the Acts so that the requirement that the Authority carries out its functions in the manner in which it considers is best calculated to contribute to the achievement of sustainable development will be of equal importance to the regard the Authority has to:

- a) the need to secure that all reasonable demands for electricity are met;
- b) the need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met; and
- c) the need to secure that licence holders are able to finance the activities which are the subject of obligations imposed by or under the Acts, the Utilities Act 2000 or the Energy Act 2004.

The provisions of the 2008 Act which will change our duties have not yet been commenced and are not likely to come into effect until the end of January 2009 at the earliest. This is an indicative timeline.

1.9. Where a network company experiences financial distress it may seek to take cost saving measures and, where possible, dispose of assets. It may also seek to renegotiate existing obligations; one obvious example would be to seek to reopen its price control. If these measures fail to improve the financial position of the company then it may become insolvent. Insolvency is a position where a company's liabilities exceed the value of its assets and it is unable to pay its debts.

Indicators of financial distress

1.10. While the financial position of a company can deteriorate quickly, generally financial distress results from the combination of effects over time. Consequently, there are a range of potential indicators or "warning signs" of financial distress. These include financial market data and commercial intelligence. We monitor such indicators on a regular basis. Chapter 2 provides further details.

Scope for financial distress

1.11. Historically, the probability of a monopoly network company becoming insolvent has been considered low. However, the growing trends of combining network companies with other, more risky activities in the same corporate group, and of highly leveraged financing structures, potentially increase the risk of financial failure. The prevailing economic conditions – particularly high input prices and tight credit market conditions – increase the likelihood of financial distress further. Nevertheless, the energy networks remain relatively low risk businesses with fixed customer bases and guaranteed revenues.

Special administration

1.12. Administration is a mechanism for dealing with an insolvent company. It is unlawful for a company to trade while insolvent. Under administration, an administrator – a qualified insolvency practitioner – is charged with attempting to restructure the company to which it is appointed so that it may resume normal trading. Alternatively, if this is impracticable within a reasonable timeframe, or a better outcome for creditors can be secured, then the administrator will sell the company or its assets and undertakings.

1.13. The process of administration is an alternative to liquidation whereby a liquidator is charged with winding-up the affairs of a company to which he is appointed, realising its assets and distributing the proceeds to creditors and, if any surplus exists, to members. In the UK the administration regime is governed by legislation, the Insolvency Act 1986, as amended by the Enterprise Act 2002, amongst others.

1.14. Reflecting the importance of energy networks to consumers, a special administration regime was established through primary legislation in the Energy Act 2004. The aim of the special administration regime is to ensure that essential services to consumers remain secure and uninterrupted in the event of a company

becoming insolvent. Similar special administration regimes are also in place for the water and rail industries. The special administration regime is discussed in further detail in chapter 2.

2. Existing arrangements

Chapter Summary

This chapter sets out a summary of the arrangements in place to address a case of financial distress. These include ring-fencing licence conditions and associated monitoring arrangements, enforcement actions and the option of re-opening a price control during a regulatory period.

In the event that the financial position of a network licensee continued to deteriorate, in the first instance recourse may be had to the special administration provisions in the Energy Act 2004.

Ring fencing provisions and associated monitoring arrangements

2.1. The licences of network companies contain a suite of conditions known collectively as the 'financial ring-fence'. The purpose of the financial ring-fence conditions is two-fold.

- Its primary purpose is to secure that the assets, cash-flows and other financial resources of regulated energy network operators are applied to meet the needs of the regulated companies. The conditions seek to ensure that those resources are not diverted to any other purposes nor exposed to any unrelated risks.
- The second purpose is to provide Ofgem with information on the financial position of licensees. This may provide early warning of financial deterioration and may facilitate the Authority to take appropriate action in the event of a breach.

2.2. Among the key provisions of the 'financial ring fence' is the requirement for the companies to provide a statement signed by a director of the licensee and accompanied by a supporting statement from its auditors setting out that the company has adequate resources to properly and efficiently carry out its functions over the next financial year.

2.3. Another provision of the 'financial ring fence' provides for a cash lock-up in certain circumstances between the licensee and its affiliates. This prohibits a parent company from taking money out of a network company and thus out of the regulated GB networks in order to address financial concerns at a Group level.

2.4. Collectively, the ring-fence conditions aim to protect the financial health of network companies, and enable us to monitor financial health and take action where necessary (including enforcement action) to seek to prevent a material deterioration in the financial health of a network company.

2.5. We recognise that the ring-fence conditions will not necessarily prevent, or indeed provide a signal for, deterioration in the financial health of network

companies. The financial health of a network company may deteriorate too quickly for the ring-fence conditions to be effective.

Monitoring arrangements

2.6. Ofgem's scope to collect information to monitor the financial health of network businesses is wider than that provided for by the ring-fencing provisions. Ofgem collects information about network licensees from a range of different sources and uses that information to monitor the performance of those companies against their price controls.

2.7. We have detailed cost and revenue reporting arrangements in place for the network companies. These arrangements include annual visits to the transmission and distribution licensees to follow up on the reporting submissions. This process provides us with a wide range of information on the financial health of network licensees. The network licensees are routinely assessed against this information and their compliance with regulatory parameters, including those set by price controls, monitored.

2.8. Where a network business faces a deteriorating financial position, one area where it may seek to save costs is by reducing its capital expenditure. We also routinely monitor the actual level of capital expenditure versus the planned level to ensure that the interests of consumers are safeguarded against under-investment. In setting the current transmission price controls for the four gas and electricity transmission companies, we included a provision that triggers an automatic review of the company's revenue allowance if that company's investment falls by 20% or more relative to its capital expenditure allowance in any year.

2.9. Separately, we also monitor general market indicators such as share prices, credit ratings and other publicly available information with a view to establishing a broader picture of financial performance and health. Therefore, in addition to the review of the companies' annual reporting requirements, we collect some information on a weekly or, in some cases, more frequent basis.

Enforcement actions

2.10. In the event that the information we receive from monitoring the performance of a network licensee demonstrates deteriorating financial health or a network company breaches any of its financial ring-fence provisions, Ofgem has the power to take a number of enforcement actions. These actions range from requesting additional information from licensees to initiating a cash lock up. Ofgem also has wider enforcement powers under the Gas Act 1986 and the Electricity Act 1989 including the power to impose financial penalties on licence holders and/or to revoke licences.

2.11. We can also impose enforcement orders on network companies. For example, we would consider whether it would be appropriate to take enforcement action in the

event that a network company under spends its capital allowance to an extent that it could be deemed not to be developing and maintaining an efficient, coordinated and economical system.

2.12. Further information on our duties and powers is set out in Appendix 2.

Overall position on Ring Fencing, Monitoring Arrangements & Enforcement

2.13. Ultimately, responsibility for the financial integrity of the network companies rests with those responsible for the management of individual licensees. Where individual licensees form part of a broader parent Group, individual network companies should ensure that they manage their relationship with the parent Group in such a way so as not to place the network company in breach of their statutory and wider regulatory obligations, or at risk of financial distress or failure. We recognise that the ring fencing provisions, associated monitoring arrangements and enforcement provisions (where appropriate) may not in all cases act to provide the Authority with sufficiently early notice to consider what action(s) if any, at its discretion, it considers appropriate to seek to prevent the financial deterioration or failure of a network company. In this regard, notwithstanding the existence of these provisions, we expect licensees, who will or ought to be aware of their financial position, to act responsibly and to inform Ofgem at the earliest stage possible of any actual or projected financial distress so that the Authority may consider what if any action to take, at its discretion, to prevent further financial distress or financial failure.

Reopening a price control

2.14. A price control sets the financial parameters within which a network company must operate over a number of years. Ofgem has generally set price controls for network companies for a period of 5 years.

2.15. In setting a price control Ofgem seeks to provide a licensee with a revenue stream that is sufficient for it to meet its statutory and regulatory obligations if it is operating in an efficient manner. Generally speaking, we believe there would need to be strong and compelling reasons to re-open a price control settlement. Re-opening an agreed package in the absence of strong and compelling reasons might be viewed as setting an undesirable precedent which would undermine regulatory certainty and regulatory predictability in future. However, we recognise that circumstances may develop in which, despite the company operating in an economic and efficient manner, the revenue stream set in a price control ceases to provide sufficient funds for a regulated company. In such cases one option is to 'reopen' a price control during a regulatory period to re-set revenue allowances or the parameters that give rise to those allowances.

2.16. Ofgem has made provision for price control re-openers in each of its current price controls that relate to specific events. For example:

-
- *Distribution Price Control Review (DPCR) 4*⁵ - in setting DPCR4 (1 April 2005 – 31 March 2010) we recognised that electricity distribution network operators (DNOs) *would be exposed to unpredictable costs* in relation to a number of areas. Under Special Licence Condition A3 DNOs may issue Ofgem with a notice that they wish to re-open DPCR4 in regard to these changes in relation to:
 - the application of regulations 17 and 18 of the Electricity Safety Quality and Continuity Regulations (ESQCR) including any amendments to the ESQCR costs;
 - secondary legislation on road occupation under the New Roads and Street Works Act (NRSWA) 1991; and
 - permit schemes introduced through secondary legislation under the Traffic Management Act (TMA) 2004.
 - *Gas Distribution Price Control Revenue (GDPCR)* - to accommodate the uncertainty associated with the first auctions of interruptible capacity on the Gas Distribution Networks Ofgem included a capital expenditure reopener provision in the 2007-2013 GDPCR⁶.

Disapplication

2.17. The examples of reopeners set out in the above paragraphs highlight specific cases where price control parameters may be reopened. Separately, there are provisions in the licences of price controlled network companies for those licensees to apply to Ofgem for the disapplication of their revenue restrictions. A disapplication request enables control parameters to be reset for a broader range of reasons than those determined by specific reopener provisions.

Using a re-opener or disapplication request to address financial distress

2.18. Where the finances of a network company continue to deteriorate despite the application of other measures then Ofgem may consider, at its discretion, reviewing price control revenue allowances or the parameters that give rise to those allowances.

2.19. Particular licence conditions may contain specific re-opener provisions which are for example tailored towards particular incentives, and are exercisable at the Authority's discretion by reference to the facts of an individual case and the relevant re-opening power. Such provisions may well not be amenable to relieving financial distress as the power may only be engaged, at the Authority's discretion, in particular circumstances which may well depend on the facts of individual cases. However, in certain circumstances, reconsidering the price control settlement by disapplication of the existing revenue restrictions may relieve financial distress. In

⁵ Electricity Distribution Price Control Review: Final Proposals – Ofgem, November 2004, #265/04
<http://www.ofgem.gov.uk/Networks/ElecDist/PriceCntrls/DPCR4/Documents1/8944-26504.pdf>

⁶ Gas Distribution Price Control Review: Final Proposals – Ofgem, 3 December 2007, #285/07
<http://www.ofgem.gov.uk/Networks/GasDistr/GDPCR7-13/Documents1/final%20proposals.pdf>

broad terms, we are minded to consider requests for disapplication of price control terms in circumstances where⁷:

- The cause of financial distress is largely due to factors beyond the company's control. These might include: (i) instances where additional workload has arisen from new legislation that was not anticipated at the time of the last review, or unanticipated consumer demand; or (ii) a material change in financial market conditions relative to those prevailing at the time a price control was set such that that an efficient company with an investment grade credit rating would no longer be able to finance its activities. It would be for the applicant company to set out the evidence and to persuade us that the causes of financial distress were beyond its control; and
- Re-opening the settlement could reasonably be expected to relieve the financial distress in a timely manner. We do not consider it would be appropriate to reopen a control unless there is a realistic prospect of reaching a definitive conclusion within the timeframe necessary to address the declining financial position of the licensee. To do otherwise may mislead investors and creditors and ultimately increase the risk to consumers in the event of insolvency.

2.20. Regulation aims to provide incentives on network companies to strive for greater efficiency to meet, and where possible better, the terms of their regulatory settlements. Therefore, where financial distress has arisen predominantly from the actions, or lack of action, of the licensee, we would be unlikely to reopen the regulatory settlement. On the other hand, where financial distress arises despite a company operating in an economic and efficient manner, we would consider the appropriate use of tools such as the disapplication of existing revenue restrictions where they are available to remedy that distress. We will consider each case on its merits. It may be that there is a combination of factors giving rise to financial distress, including some level of inefficiency, poor management or inappropriate financial structure.

2.21. In no sense should the reopener process be viewed as a mechanism to bail out an inefficient, poorly managed network company or a network company that has excessive gearing.

2.22. In the event that a disapplication request was submitted in relation to a case of deteriorating financial health we would seek to make a decision on such an application in a timely manner and in a manner consistent with our public law and wider statutory duties.

⁷ In setting out these criteria, the Authority is not fettering its discretion in respect of the application or interpretation of the criteria in the circumstances of a particular case, or in respect of any additional criteria the Authority may identify as relevant in the circumstances of a particular case.

Special administration regime

2.23. Should a network company in financial distress choose not to apply for its regulatory settlement to be reopened, a reopener application be unsuccessful or a re-opener fail to alleviate the distress, the company concerned may become insolvent. In such cases the special administration provisions, set out in chapter 3 of the Energy Act, apply.

2.24. The special administration arrangements are designed to ensure that a qualified insolvency practitioner – an administrator – can be appointed to fulfil the regulatory obligations of the network company. There are a number of stages in administration. These can broadly be summarised as follows.

Stage 1 – Applying for an energy administration order

2.25. In the first instance, the Secretary of State for Energy and Climate Change (the Secretary of State) or Ofgem with the consent of the Secretary of State would apply to the Court for an energy administration order. The energy administrator is appointed where, on hearing the application, the Court makes an energy administration order.

Stage 2 – Providing information to the administrator

2.26. Ofgem may provide the administrator with information relating to the network company. This is likely to include information on its licence and its regulatory reporting requirements and other obligations.

Stage 3 – Administrator manages the affairs of the licensee

2.27. The administrator would manage the affairs and property of the licensee with a view to achieving the objective of administration. The objective of administration is to ensure that the licensee's system continues to be maintained and developed as an economical system and that ultimately it becomes unnecessary for the energy administration order to remain in force. The latter is achieved when either the licensee is rescued as a going concern or its assets are transferred to another party.

2.28. If the administrator is in a position to rescue the company then the process would proceed to Stage 5. If however, the best outcome is to transfer assets to another company/companies then they would proceed to Stage 4.

Stage 4 – Expressions of interest and sale of a licensee

2.29. In the event that a licensee is unlikely to be rescued as a going concern then other companies may express an interest in purchasing its assets. Ofgem would assess any issue with the sale and advise the Secretary of State accordingly. If the

transfer of assets is to proceed, appropriate licensing changes will be made and, where appropriate, adjustments to price control arrangements.

Stage 5 – End of administration process

2.30. The end of the administration process occurs with the rescue of the licensee as a going concern or the sale of a licensee and the transfer of its assets to another company. In the event that there are outstanding costs from the administration process, the Energy Act makes provision for these costs to be recovered from other licensees. These costs will ultimately be passed on to consumers.

Overall position

2.31. In terms of the matters raised in this chapter, we are mindful that any case of financial distress or failure that emerges will likely turn on its own particular facts and may well require tailor made solutions. As such, neither this document which seeks to provide a high level summary of the arrangements currently in place nor the procedural manual that we propose to publish in 2009 for guidance purposes, are intended to fetter the scope of the Authority's powers or discretion whether under licence, statute or otherwise. Equally, neither document is intended to create any legitimate expectation that specific cases will be dealt with in a particular manner.

3. Reviewing the existing arrangements

Chapter Summary

This chapter sets out our proposal to review the existing arrangements for monitoring financial health and for responding to a case of financial distress. It sets out our intention to develop and publish a procedural manual detailing our approach to responding to the financial distress of a network licensee and to test that manual by running a simulation exercise.

Monitoring arrangements

3.1. As set out in chapter 2, Ofgem has arrangements in place to monitor the performance and financial health of network companies. In light of the prevailing economic conditions, we consider it is an appropriate time to review the existing monitoring arrangements to determine whether they continue to provide us with the best possible information on the financial health of network licensees in a timely manner. If we consider any changes to the existing arrangements may be beneficial then we will fine-tune our monitoring arrangements accordingly. Key issues we intend to consider are:

- whether there are any other sources of information that we can identify as important;
- the timing of when we receive and monitor information; and
- the balance between quantitative and qualitative sources of information.

3.2. In some cases we may consider doing more with the information that we currently review. In other cases we may seek additional information from network companies or to monitor information from other external sources. For example, network companies such as Independent Gas Transporters and Independent Distribution Network Operators are currently not required to provide the same level of information as Gas Transporters or Distribution Network Operators. Therefore, we will consider the merits of introducing additional information requests for those parties.

3.3. If any changes are identified, including the collection of any additional information, then we will seek to introduce these for the beginning of the next financial year, i.e. from 1 April 2009.

Procedural manual

3.4. As highlighted in chapter 2, there are a number of different arrangements currently in place that enable Ofgem to respond where a network licensee experiences deteriorating financial health. These arrangements are set out in a range of documents including the financial ring-fence conditions in the network licences and the special administration provisions in the Energy Act 2004.

3.5. The purpose of the procedural manual will be to set out in a single document a detailed response plan to a case of financial distress, providing guidance and clarity of the indicative process to stakeholders.

3.6. We intend that the key components of the procedural manual will be:

- details of the enforcement actions that Ofgem may take in response to a case of financial distress;
- details on the circumstances in which provisions to re-open price controls could be triggered, and the procedure for re-opening a price control;
- an action plan detailing the key stages of an administration procedure from the processes for putting a licensee into special administration to the end of an administration process;
- details of key documents to be made available to the administrators and advisers;
- outline of the interactions with external parties including the Department of Energy and Climate Change (DECC) and, if necessary, the Health and Safety Executive (HSE);
- the issues associated with financing the cost of administration; and
- a risk matrix and possible mitigating actions that could be taken to address risks.

Testing the arrangements – simulation exercise

3.7. To test fully the effectiveness of the arrangements Ofgem has in place to respond to a case of financial distress, we intend to undertake a simulation or “War-Games” exercise. This exercise involves running a scenario based on a potential event a network operator could face. For example, insolvency of a large debtor.

3.8. We propose to reflect the lessons of the exercise in the procedural manual before we publish it on our website.

4. Next steps and timetable

Chapter Summary

This chapter sets out the proposed milestones for this project and our proposed approach to external engagement.

4.1. We aim to complete and publish on our website the procedural manual for addressing cases of energy network company financial distress in spring 2009. The key indicative dates in this process are set out in the following table.

Table 1 – Project milestones

Date	Milestone
December 2008 – January 2009	Develop procedural manual
December 2008 – March 2009	Review efficiency of current monitoring arrangements and (if required) seek additional information from network licensees
Q1 2009	Publish draft procedural manual
Q1 2009	Hold “War-Games” exercise
Q2 2009	Update procedural manual
Q2 2009	Publish procedural manual
1 April 2009	Implement any changes to monitoring arrangements

External engagement

4.2. We are committed to working openly and effectively with Government, industry and other interested parties. It is for this reason that we have published this position paper and why we intend to publish our final procedural manual. We also intend to publish a draft of our procedural manual to seek industry views.

Appendices

Index

Appendix	Name of Appendix	Page Number
1	Legal framework	18
2	The Authority's powers and duties	24
3	Glossary	26

Appendix 1 – Legal framework

Principal objective and general duties

1.1. The Authority's principal objective in carrying out its functions under the Gas Act and the Electricity Act is to protect the interests of consumers, present and future, wherever appropriate by promoting effective competition. The implications of a network company experiencing financial distress directly impacts consumers. Section 9 of the Gas and Electricity Acts set out the general duties of licence holders. Section 9(2)(a) of the Electricity Act and section 9(1)(a) of the Gas Act requires the holders of network licenses to develop and maintain an efficient, co-ordinated and economical system of electricity transmission or pipe-line system for the conveyance of gas. Where their financial position deteriorates, network companies may struggle to invest appropriately to maintain and develop their networks. As a consequence, they may not be able to meet customers' demands for connections and energy transfers. If those conditions prevail overtime then there may be a threat to security of supply.

1.2. The Authority must have regard to a number of other factors in carrying out those functions, a number of which are relevant in circumstances where a licensee is facing financial distress. Most notably, the Authority has a duty to secure that licensees are able to finance their obligations under the Gas Act and Electricity Act. This does not mean Ofgem would be expected to provide regulatory relief to alleviate a licensee's financial distress in all circumstances. In circumstances of financial distress, Ofgem would need to consider the reasons why the licensee was in that position and whether it resulted from factors of the licensee's making or from factors beyond their control. One example of an action Ofgem has taken to secure licensees are able to finance their obligations was to introduce financial ring-fencing aimed at protecting network licensees against financial pressures arising elsewhere. These measures are discussed in further detail below.

1.3. The Authority must also have regard to the need to secure that, so far as it is economical to meet them, all reasonable demands for gas and electricity are met. Under circumstances of financial distress a licensee may not be able to adequately invest in its networks. This could provide a threat to security of supply meaning that reasonable demands for gas and electricity may not be met.

1.4. Subject to these considerations, the Authority is also required to carry out its functions in the manner it considers is best calculated to protect the public from dangers arising from the conveyance of gas through pipes or the use of gas conveyed through pipes and from the generation, transmission, distribution or supply of electricity. The Gas Act 1986 allows the Authority to make regulations for guaranteed standards of performance, with the consent of the Secretary of State, and to determine overall standards of performance for gas transporters. Guaranteed standards of performance set service levels that must be met in each individual case. Overall standards of performance set minimum average levels of performance in areas where it is not necessarily appropriate to put in place guarantees for individual

customers. These arrangements are a key balance to price control incentives to reduce costs and therefore provide consumers some protection. However, where a licensee experiences financial distress its ability to invest in networks and to meet its required standards may well be diminished. If underinvestment in networks persists then it could, in the case of gas transporters, pose public safety issues. The Health and Safety Executive (HSE) is the statutory body responsible for regulating consumer gas safety in Great Britain. Among other things it enforces the safety and supply emergency prevention provisions of the Gas Safety Management Regulations (GSMR) 1996⁸.

1.5. A summary of the Authority's powers and duties is set out in Appendix 2.

Provision of information to the Authority

1.6. All licences contain provisions requiring the licensees and their ultimate controllers to provide information in a manner and in a timeframe reasonably requested by the Authority. In the case of the network licensees to whom the special administration provisions apply the relevant conditions are Standard Condition 24 of the electricity distribution licence, Standard Special Condition A26 of the gas transporters licence (DNs and NTS), Standard Condition 24 of the gas transporters licence (Independent Gas Transporters) and Standard Condition B4 of the transmission licence. In circumstances where a licensee may have deteriorating financial health and Ofgem is aware of this situation, we will consider whether we should write to the licensee to request additional information.

1.7. In addition, Standard Condition B7 of the transmission licence, Standard Condition 44 of the electricity distribution licence, Standard Special Condition A37 of the gas transporters licence (DNs and NTS) and Standard Condition 44 of the gas transporters licence require the licensees to provide an 'Availability of Resources Statement' confirming that the licensee has resources to properly and efficiently carry out its duties and that, in the opinion of their Directors, they have sufficient financial resources and financial facilities available to continue to carry out their activities for the next 12 months. This condition also applies to Independent Gas Transporters and Independent Distribution Network Operators. At the last Transmission Price Control Review (TPCR) and the Transmission GDPCR the requirement was added to those licences requiring the licensee to provide a forward looking cash flow forecast, movement of net debt and analysis of net debt statement for the next 12 months. The electricity distribution licences do not currently contain this clause but this may be introduced at DPCR5.

⁸ Gas Safety Management Regulations 1996 (No 551)
http://www.opsi.gov.uk/si/si1996/Uksi_19960551_en_1.htm

Financial ring-fence

1.8. One of the measures the Authority has taken to safeguard against financial distress was to introduce “financial ring-fence” licence conditions into the licences of network companies aimed at protecting them against financial pressures arising elsewhere in the Group and aimed at ensuring that their financial resources are not exposed to inappropriate risks nor diverted to other purposes.

1.9. While introduced at different times, the licence conditions relating to financial ring-fencing for the network companies were standardised in the licences determined by the Secretary of State pursuant to the Utilities Act 2000. In further developing the relevant licence conditions since 2000, Ofgem has maintained a standardisation approach with the aim of ensuring that the ring-fence conditions were substantially the same in all energy network licences.

4.3. The key licence conditions and their purposes are as follows:

- **Disposal of relevant assets** – This condition requires the licensee to provide written notice to the Authority of any proposed disposal of operational control of any assets forming part of its network.

The purpose of this condition is to prevent a licensee relinquishing control of any asset that may be critical to the operation of that network without making Ofgem aware of it, giving the Authority the opportunity to prevent the sale or other disposal if it believes it does not serve the interests of consumers and network users.

- **Availability of resources** – This condition requires the licensee to ensure it has sufficient resources to carry on its licensed activities for a period of 12 months and to submit a report to the Authority annually, supported by the licensee’s external auditors, confirming availability of financial resources. The condition also prevents the licensee from making or paying any dividend that would cause it to be in breach of its financial ring fence conditions at any future time.

The purpose of this condition is to ensure that a network company always expects to have at its disposal the resources to maintain and develop an efficient, economic and coordinated system. This condition provides us with information for monitoring purposes including a cashflow forecast, movement of net debt and analysis of net debt.

- **Restriction on activity and financial ring-fencing** – This requires the licensee not to conduct any activities other than those of its core business, subject to certain exceptions and specific limitations on the turnover and investment of permitted non-core activities. It also requires the licensee not to enter into an agreement incorporating a cross-default obligation without the consent of the Authority.

The purpose of this condition is to prevent a licensee assuming material risks that are unrelated to its regulated activities and which may jeopardise its financial position in the event of an adverse outcome. Ofgem's power under this condition stems from its discretion to withhold granting consents unless a licensee sufficiently assuages the Authority's concerns on the risks associated with certain activities.

- **Credit rating** – This condition requires the licensee to maintain an investment grade credit rating.

The purpose of this condition is to ensure that licensees finance themselves and manage their operations in an efficient manner and by doing so ensure that they maintain ready access to sources of liquidity and capital on reasonable terms. Where a licensee experiences a reduction in its investment grade status it may trigger cash lock-up provisions under the indebtedness condition. This is discussed below.

Where a licensee is not eligible for a credit rating, for example as is the case for a number of smaller licensees such as Independent Gas Transporters and Independent Distribution Network Operators, we have approved alternative arrangements involving the parent company of a licensee entering into a 'keep well' agreement which sets out a series of undertakings in favour of the licensee.

- **Indebtedness** – This condition requires the licensee not to incur any indebtedness nor create any security, nor guarantee any liability of another person, other than on certain specified terms and for a permitted purpose, or otherwise without consent of the Authority. It also provides for a cash lock-up in certain circumstances between the licensee and its affiliates.

The purpose of this condition is to ensure that a licensee only assumes liabilities relating to the conduct of its own business and activities and does not become exposed to risks that may jeopardise its financial position outside of those activities. The cash lock-up provisions ensure that the licensees conserve cash and other sources of value when its investment grade credit rating is at risk of being, or is, compromised. Ofgem's powers under this condition stems from its discretion to withhold granting consents in relation to the additional liabilities the licensee may assume and in relation to its transactions with affiliates.

- **Undertaking from ultimate controller** – This requires the licensee to obtain an undertaking from its parent company and any other ultimate controllers that it will refrain from taking any action which may cause the licensee to breach its obligations under the Gas or Electricity Act or its licence.

The purpose of this condition is to prevent a holding company or other ultimate controller from using its influence to cause the licensee to act inconsistently with the requirements of its licence and statutory obligations including most notably its requirement to maintain and develop an efficient system and the other ring-fencing conditions.

Insolvency Act 1986

1.10. The Insolvency Act 1986 sets out a procedure – administration – whereby a company that experiences financial distress may obtain a moratorium on the requirement to repay debts while an administrator is appointed. The administrator would be appointed under a court administration order and charged with attempting to restructure the company to which he is appointed so that it may resume normal trading, or if this is impracticable within a reasonable timeframe, or if a better outcome could be thus secured (for creditors and members), selling the company or its assets. The principal role of the administrator under the Insolvency Act is to act in the interests of all of the creditors and to seek to rescue the company as a going concern.

1.11. The detailed provisions for the formal insolvency procedures of the Insolvency Act 1986 are set out in the Insolvency Rules 1986⁹.

Energy Act 2004

1.12. A special administration regime was established through primary legislation in the Energy Act 2004. Chapter 3 of the Energy Act 2004 (sections 154 to 171) contains provision for a special administration regime for monopoly energy licensees defined as a 'protected energy company'.

1.13. The Energy Act modifies certain provisions of the Insolvency Act 1986. In particular, it imposes a duty on an energy administrator to continue to maintain and develop the network of the insolvent licensee during administration thus ensuring continuity of supply.

1.14. Under the provisions of section 156 of the Energy Act 2004, if a protected energy company becomes insolvent, the Secretary of State, or the Authority with the consent of the Secretary of State, may apply to the Court for an order to place the licensee into energy administration. Once in administration, the administrator is required under sections 158 and 159 to perform its duties so as to achieve the objective of energy administration. Section 155 sets out the objective of energy administration as being:

- to secure that the company's system is, and continues to be maintained and developed as, an efficient and economical system; and
- that it becomes unnecessary for the energy administration order to remain in force.

⁹ Insolvency Rules 1986 - Statutory Instrument No. 1986/1925.

1.15. Section 155 also sets out the means by which an energy administration order becomes unnecessary. Those means are:

- the company is rescued as a going concern; or
- its assets and licence are transferred to another company – the “successor company”.

Cost recovery mechanism

1.16. Standard Condition C24 of the Transmission Licences, Standard Condition 15 of Electricity Supply Licences, Standard Condition B19 of the Gas Shippers’ Licences and Special Condition C22 of Gas Transporter Licence contain provisions enabling the Secretary of State to recover certain monies (“shortfall”) that may have been made to a protected energy company that encountered a shortfall while in energy administration. The licence conditions require the licensees to modify their charges to recover the increased revenues from their customers. Ultimately, the costs are likely to be passed down the supply chain and recovered from energy consumers.

Energy Administration Rules 2005

1.17. In exercising the powers conferred on him by section 159(3) of the Energy Act 2004 and section 411 of the Insolvency Act 1986, the Lord Chancellor made the Energy Administration Rules 2005¹⁰ which came into force on 1 October 2005 and apply to protected energy companies in England and Wales and the Energy Administration (Scotland) Rules 2006¹¹ which came into force on 6 April 2006 and apply to protected energy companies in Scotland. The rules set out the detailed procedures governing how energy administration must be conducted. The rules covers all aspects of administration such as the appointment of an energy administrator, process of energy administration, ending energy administration and court procedure and practice.

¹⁰ Energy Administration Rules 2005 - Statutory Instrument 2005 No. 2483

¹¹ Energy Administration (Scotland) Rules 2006 - Statutory Instrument 2006 No. 772 (S.8)

Appendix 2 – The Authority’s Powers and Duties

1.1. Ofgem is the Office of Gas and Electricity Markets which supports the Gas and Electricity Markets Authority (“the Authority”), the regulator of the gas and electricity industries in Great Britain. This Appendix summarises the primary powers and duties of the Authority. It is not comprehensive and is not a substitute to reference to the relevant legal instruments (including, but not limited to, those referred to below).

1.2. The Authority’s powers and duties are largely provided for in statute, principally the Gas Act 1986, the Electricity Act 1989, the Utilities Act 2000, the Competition Act 1998, the Enterprise Act 2002 and the Energy Act 2004, as well as arising from directly effective European Community legislation. References to the Gas Act and the Electricity Act in this Appendix are to Part 1 of each of those Acts.¹²

1.3. Duties and functions relating to gas are set out in the Gas Act and those relating to electricity are set out in the Electricity Act. This Appendix must be read accordingly¹³.

1.4. The Authority’s principal objective when carrying out certain of its functions under each of the Gas Act and the Electricity Act is to protect the interests of consumers, present and future, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the shipping, transportation or supply of gas conveyed through pipes, and the generation, transmission, distribution or supply of electricity or the provision or use of electricity interconnectors.

1.5. The Authority must when carrying out those functions have regard to:

- The need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met;
- The need to secure that all reasonable demands for electricity are met;
- The need to secure that licence holders are able to finance the activities which are the subject of obligations on them¹⁴; and
- The interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.¹⁵

1.6. Subject to the above, the Authority is required to carry out the functions referred to in the manner which it considers is best calculated to:

¹² entitled “Gas Supply” and “Electricity Supply” respectively.

¹³ However, in exercising a function under the Electricity Act the Authority may have regard to the interests of consumers in relation to gas conveyed through pipes and vice versa in the case of it exercising a function under the Gas Act.

¹⁴ under the Gas Act and the Utilities Act, in the case of Gas Act functions, or the Electricity Act, the Utilities Act and certain parts of the Energy Act in the case of Electricity Act functions.

¹⁵ The Authority may have regard to other descriptions of consumers.

- Promote efficiency and economy on the part of those licensed¹⁶ under the relevant Act and the efficient use of gas conveyed through pipes and electricity conveyed by distribution systems or transmission systems;
- Protect the public from dangers arising from the conveyance of gas through pipes or the use of gas conveyed through pipes and from the generation, transmission, distribution or supply of electricity;
- Contribute to the achievement of sustainable development; and
- Secure a diverse and viable long-term energy supply.

1.7. In carrying out the functions referred to, the Authority must also have regard, to:

- The effect on the environment of activities connected with the conveyance of gas through pipes or with the generation, transmission, distribution or supply of electricity;
- The principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed and any other principles that appear to it to represent the best regulatory practice; and
- Certain statutory guidance on social and environmental matters issued by the Secretary of State.

1.8. The Authority has powers under the Competition Act to investigate suspected anti-competitive activity and take action for breaches of the prohibitions in the legislation in respect of the gas and electricity sectors in Great Britain and is a designated National Competition Authority under the EC Modernisation Regulation¹⁷ and therefore part of the European Competition Network. The Authority also has concurrent powers with the Office of Fair Trading in respect of market investigation references to the Competition Commission.

¹⁶ or persons authorised by exemptions to carry on any activity.

¹⁷ Council Regulation (EC) 1/2003.

Appendix 3 - Glossary

A

Administration

A mechanism for dealing with an insolvent company whereby a qualified insolvency practitioner is charged with attempting to restructure the company so that it may resume normal trading.

The Authority (Ofgem)

Ofgem is the Office of Gas and Electricity Markets, which supports the Gas and Electricity Markets Authority (GEMA), the body established by Section 1 of the Utilities Act 2000 to regulate the gas and electricity markets in Great Britain.

C

Capital Expenditure (Capex)

Expenditure on investment in long-lived transmission assets, such as gas pipelines or electricity overhead lines.

D

DECC

Department of Energy and Climate Change.

Distribution Network Operators (DNOs)

Holders of electricity distribution licences. Licences are granted for specified geographical areas. There are fourteen licensed distribution areas.

DPCR 4

The price control review for the electricity distribution network operators conducted in 2003 & 2004. The resulting price control covers the years 2005 to 2010.

E

Electricity, Safety, Quality and Continuity Regulations 2002 (ESQCR)

The ESQCR specify safety standards, which are aimed at protecting the general public and consumers from danger. In addition, the regulations specify power quality and supply continuity requirements to ensure an efficient and economic electricity supply service to consumers.

Enterprise Act 2002

The Act made a number of important reforms, designed to crack down on abuses that harm consumers and fair-trading businesses alike and thus encourage productivity and enterprise. Included in the Act are provisions relating to market investigation references, super complaints and the enforcement of consumer legislation.

G

Gas distribution networks (GDNs)

GDNs transport gas from the National Transmission System to final consumers and to connected system exit points. There are currently eight GDNs in Great Britain which comprise twelve local distribution zones.

Gas Distribution Price Control Review (GDPCR)

The review of the price control applying to gas distribution networks. The last review took place in 2007 and the resulting price control covers the years from 2008 to 2013.

GB Transmission

The system of high voltage electric lines providing for the bulk transfer of electricity across Great Britain.

Gearing

Ratio of a company's level of long-term debt to its equity.

H

Health and Safety Executive (HSE)

The Health and Safety Commission is responsible for health and safety regulation in Great Britain. The Health and Safety Executive and local government are the enforcing authorities who work in support of the Commission.

I

Independent Distribution Network Operators (IDNOs)

Holders of electricity distribution licences which own and run networks embedded in the DNO networks.

Independent Gas Transporters (IGTs)

Holders of gas transporter licences which develop operate and maintain local gas transportation networks.

Insolvency

Where a company's liabilities exceed the value of its assets and it is unable to pay its debts.

N

National Transmission System (NTS)

National Grid's high pressure gas transmission system. It consists of more than 6,400 km of pipe carrying gas at pressures of up to 85 bar (85 times normal atmospheric pressure).

O

Ofgem

See definition of the Authority.

Offshore electricity transmission networks

Offshore electricity transmission networks will be required to transmit electricity from offshore renewable generators to customers via the onshore transmission and distribution networks.

R

Reopener

A process to re-set revenue allowances (or the parameters that give rise to revenue allowances) under a price control before the scheduled next formal review date for the relevant price control.

T

Traffic Management Act (TMA)

The Traffic Management Act is intended to provide better conditions for all road users through proactive management of the national and local road network.

W

War-Games exercise

A simulation exercise to test the robustness of a set of arrangements.