ARRANGEMENTS ON SUPPLIER DEFAULT AND LICENCE REVOCATION

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Introduction

This paper seeks views on the arrangements that should be made to deal with circumstances where an electricity supplier finds itself in serious financial difficulties. If the supplier in question becomes insolvent, this may lead the Director General of Electricity Supply (the Director) to revoke its licence to supply electricity. The paper therefore also reviews the arrangements to deal with circumstances where the Director revokes a supply licence.

Arrangements on Licence Revocation

The grounds on which a supply licence may be revoked are set out in a Schedule to the licence. The provisions are common to all licences.[1] A copy of the relevant provisions are attached at Annex A. In summary, the grantor of the licence may revoke the licence on 30 days' notice if the licensee:

a) agrees that its licence should be revoked;

b) does not pay its licence fees;

c) fails to comply with an enforcement order;

d) fails to comply with an order made by the Secretary of State under competition law;

e) does not supply electricity for 5 years;

f) is unable to pay its debts, has a receiver appointed or other specified circumstances relating to financial failure; or

g) has committed an offence in applying for the licence.

These provisions are set out in a schedule to the licence rather than as licence conditions, and hence are not subject to the licence amendment processes under the Act. The only means by which these terms can be revised is for the existing licences to be surrendered and new licences issued.

In the initial licences put in place in 1990, no special arrangements in respect of customers were made to deal with circumstances where a supply licence was revoked.

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[1] Save that licences granted by the Secretary of State are revocable only by him, whilst those (the majority) granted by the Director are revocable by the Director.

Similarly, the Act is silent on the steps that should be taken. Following discussion with the industry and customer representatives, OFFER concluded that this was not wholly satisfactory from 1998. Accordingly, a number of amendments have been made to supply licences. The primary purpose of these amendments is to provide customers with an ability to terminate their contract with the supplier whose licence was to be revoked and to make new arrangements with the supplier of their choice. In addition, all supply licences contain a provision' which may be used when the Director has given notice of his intention to revoke the licence of a supplier. Under the relevant condition, the Director may instruct any other supplier to write to the customers of the first supplier. The letter must tell each customer that his supplier can no longer supply him and that the customer must enter into a new contract with a supplier of his choice or request a tariff supply from his local public electricity supplier (PES). The letter should also set out the terms upon which the notifying supplier is, if requested, prepared to supply electricity. Where the licence is revoked the supplier's Designated (ie domestic and small business) Customers will be able to terminate their supply contracts. The supplier may itself terminate these contracts.[3]

It is, of course, appropriate that customers are allowed adequate time to make alternative arrangements for their electricity supply. If the licence provisions are triggered at more or less the same time as notice of revocation is given, customers should be informed about four weeks prior to the actual date of revocation.

This period would enable customers either to enter arrangements with the new supplier that has contacted them or to make alternative arrangements with another supplier of their choice. During this time customers may also need to change payment arrangements, for example to terminate direct debit arrangements with the old supplier.

Some concerns have been expressed about the position of customers who fail to make new arrangements in such circumstances. If the customer failed to terminate his existing contract or failed to enter a new arrangement, there would be no clearly established contract position with a licensed supplier. To protect other industry parties it is assumed that in these cases the local PES would have to disconnect the supply until a contract (or tariff) was agreed.

During discussions on these issues customer representatives and some suppliers queried whether there was scope for the automatic transfer of customers to a new supplier. The existing legislation makes no provision for this, so any so-called automatic transfer would have to be provided for contractually.

A number of proposals were considered which were designed to achieve this. These included a proposal by the then Legal Working Group of the Competitive Supply Code Executive in July 1996 (which was considered in the August 1996 Licence Overview Document), a proposal by the PESs' legal advisers in July 1997 (considered in the August 1997 Licence Overview Document) and a proposal by the Pool Chief Executive's Office in November 1997. In summary, however, all have a broadly

[2] Condition 7A of the PES Licence, appended as Annex B to this paper, and Condition 23 of the Second Tier Supply Licence.
[3] PES Licence Condition 39 paragraph 3.

similar approach in requiring that the initial supply contract between the customer and the second tier supplier includes a provision to enter a new contract (or tariff supply) with another supplier should the initial supplier have its licence revoked. In general, it is assumed that the fall-back supplier would be the local PES.

In addition to some legal concerns about the validity of the earlier proposals, all the proposals involve a distinction between tariff and contract supply. Some second tier suppliers have expressed concern that the approach is anti-competitive.

First, it would add to the length of the documents which customers must sign on taking a second tier supply. PES supply would involve less documentation and therefore be presentationally more attractive. Second, it could be taken tacitly to convey the message that second tier supply, unlike that provided by PESs, is unreliable.

To be legally robust the provisions in the supply contracts would need to be highlighted and specify in sufficient detail what the customer was agreeing to. In particular, if the new supply is contractual, it would be important to make clear what provisions applied to termination of the new contract. In practice the provision could add significantly to the length and complexity of supply contracts.

These disadvantages need to be set against the likelihood of supplier revocation and the problems likely to emerge in practice if such provision is not made. To date no active supplier has had its licence revoked nor have customers been adversely affected by a supplier leaving the market. Should, however, revocation occur then in practice most customers can be expected to make new arrangements. Those who do not make formal arrangements may be content to pay the new supplier who has contacted them about their supply. It should be recalled that many customers do not presently have formal written arrangements with their local public electricity supplier. Indeed, some PESs do not seek written supply requests in all cases. Whilst this may not be good practice from a consumer perspective, it demonstrates that supply, and payment for supply, can continue in a range of circumstances notwithstanding some uncertainty about the precise legal position.

Nevertheless, this position is not wholly satisfactory. It is generally agreed that this issue would best be resolved by new legislation. The Gas Act 1995 enables the existence of a supply contract between a customer and a supplier to be deemed where the customer fails to make new arrangements.[4] The present Electricity Act does not, however, provide for these arrangements. Further primary legislation, whilst a possibility in the medium term, could not be enacted for some time. The introduction of new legislation is of course a matter for Government, but OFFER would welcome the amendment of the Electricity Act 1989 to provide a similar provision to that in the Gas Act 1995.

Given the disadvantages and risks associated with the proposals for an automatic transfer provided for under contract, the likely extent of risks to customers and other suppliers in the event of licence revocation, and the possibility of new legislation,

[4] see paragraph 8 of Schedule 2B to the Gas Act 1986

OFFER concluded that in the context of licence revocation it would not be appropriate to require suppliers to make such provisions in their contracts. The new licence conditions agreed with suppliers reflect this position.

Arrangements on Supplier Default

A supplier facing serious financial difficulties will not necessarily have its licence revoked and, where it does so, revocation will not take place until sometime after it has defaulted on payments to other industry parties under the terms of various industry agreements. Some industry parties have expressed concerns about this.

Each electricity supplier must, in order to supply its customers, enter into a number of contracts with other members of the industry. The most important of these relate to:

- the purchase of electricity from generators through the Pooling & Settlement Agreement

- the use of the transmission system operated by National Grid plc for the transmission of electricity at high voltage ('TUoS')

- the use of the distribution systems operated by PESs for the local distribution of electricity ('DUoS')

For the purposes of this paper, a 'supplier in default' is a supplier which is in default of one or more of these agreements for failing to make payments in accordance with its (or their) terms.

It is important to note that, from 1998, a supplier of electricity will be registered in a metering point administration system (MPAS) in respect of each metering point through which it supplies a customer. It will remain registered until its customer changes supplier or until the registration is removed because the customer's premises are permanently disconnected. Other than in cases of disconnection, there is no provision in MPAS for a supplier's registration to be removed without another supplier being registered in its place.

MPAS will be used to calculate the amount of each supplier's liability for the services provided under the above-mentioned agreements. Electricity is consumed through each metering point, and charges for its generation, distribution etc. will therefore be allocated to the supplier registered against that point. In practice these services do not end merely because the legal agreements for them have terminated. The services continue to be provided, without positive action on the part of the provider, whilst the customers of the supplier in default continue to take electricity through the metering points against which that supplier is registered. Accordingly, if the registered supplier it is unable to pay these charges, the creditors of that supplier - notably generators and PESs - will be faced with increasing bad debt as the consumption of electricity continues.

There are existing provisions in industry agreements to deal with such issues. Existing use of system agreements provide for the disconnection of final customers if use of system charges are not paid. In addition, in principle, use of system agreements also provide for security to be provided by suppliers against future payment although in practice this possibility has not been widely used.

Under the Pooling and Settlement Agreement (PSA) various provisions are made in respect of defaulting suppliers. In summary, suppliers must provide the equivalent of 28 days' security cover for their electricity purchases under the PSA or have an approved credit rating or comply with another arrangement considered as suitable by the Pool Executive Committee. After the security cover is used up, payment to Pool creditors (which in practice means generators) are reduced pro rata. The Pool creditors may however instruct the Grid or the local PES to use all reasonable endeavours to disconnect the defaulting supplier. In practice this would mean disconnecting supplies to some or all of the defaulting supplier's customers, although in the case of a PES defaulting it could involve disconnecting the PES from the Grid. The Grid and/or the PES are given an indemnity by all Pool Members against any liability, loss or damage it may incur as a result of carrying out this work.

The PSA makes special provision in the case of a public electricity supplier defaulting. In such cases all Pool Members (not just creditors/generators) share the cost of the default for up to 28 days. If at the end of that period the matter is not resolved, the only option for Pool Members which is provided for under the PSA is to ask the Grid to disconnect the PES system. In practice it is assumed that this would not happen as the 28 day period would provide the PES and Pool Members concerned, together with OFFER (and potentially the Government), an opportunity to resolve the matter. In effect therefore the provisions recognise the need to intervene on a case by case basis.

Some Pool Members have expressed concern that these provisions may be insufficient for the circumstances of the market from 1998. They argue that the risks of the new market are greater and that a greater variety of suppliers may take part. This tends to increase the risk that a supplier will default. They also express concern that in the context of domestic customers the threat of disconnection is not credible. This is because of the likely extent of public concern about widespread disconnections and the costs that would be incurred in carrying out such a policy.

To address these concerns the Pool has considered a proposal involving the automatic transfer of customers following an event of default. Under this proposal if a supplier had defaulted on its Pool bill for five days its customers would be transferred to another supplier. This transfer would be facilitated in the manner described above in respect of licence revocation. In essence, however, this would involve including a provision in all supply contracts to obtain the customer's consent to the transfer to the local PES. This would have the effect of limiting the exposure of generators and would provide a rapid means by which the defaulting suppliers' customers would be transferred. In many cases the approach would trigger the transfer of customers prior to the point at which the licence could be revoked.

This would be a significant step. A supplier in difficulties would rapidly find itself without customers. In practice this would guarantee its financial failure given that by losing its customers it would lose its main source of income. This would in turn lead in due course to licence revocation. In practice therefore the steps taken on supplier default in the Pool would lead to supplier insolvency and licence revocation.

Notwithstanding the arrangements made in the Pool (or in use of system agreements) the process of licence revocation, which was included in all licences, takes some time to bring into effect. It is not necessary that a supplier is insolvent for the Director to revoke its licence. However, the earliest point at which financial difficulties can constitute a ground of licence revocation is where a supplier is unable (within the meaning of the Insolvency Act 1986') to pay debts amounting to more than £250,OOO. This requires that a statutory demand has been issued but remains unpaid after 3 week[6].

The decision to revoke a supply licence is a discretionary one. Even where a ground of revocation exists, it is possible that the Director would not wish to give notice of revocation immediately. The best resolution of the issues surrounding supplier default may be that the supplier's business is able to be sold as a going concern. The Director may wish to allow time for this to be explored in cases in which it appears a possibility, and this aim would be frustrated by licence revocation. Moreover, even after the decision to revoke is taken, the revocation cannot take effect before a 30 day notice period has expired.

It may therefore not be possible or expedient to revoke a licence until some weeks after the supplier has begun to be in default of payment under an agreement. In the interim, the supplier may incur significant financial liabilities to its service providers which it is ultimately unable to pay. Whilst the security cover to be provided by the supplier under its contracts may meet some of this debt, there could be no guarantee that it would do so completely.

In exercising his discretion concerning licence revocation, the Director will be aware and take account of the interests of a number of parties - the supplier itself, its customers, its creditors within the industry - and the promotion of competition in electricity supply generally. He will also consider whether the supplier is likely to be able to resolve its financial difficulties, or to be sold as a going concern. The Director's decision must be made in accordance with processes and principles defined by public law.

Proposals for alternative arrangements, which facilitate the transfer of a supplier's customers when a certain level of debt has been reached or a period of default has expired, must lack this element of discretion. They may lead to the demise of suppliers whose businesses could have been saved, they are not reviewable and they do not take into account the customer interest in any given situation. Arguably, they add to the

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[5] Schedule 2 to the supply licences, paragraph l(f)(i).

[6] s. 123 of the Insolvency Act 1986.

risks to which new entrants to the electricity supply market are exposed, and therefore have a tendency to be anti-competitive.

As noted earlier, the rapid transfer of customers may also give rise to difficulties for customers. The process itself is likely to cause some confusion. Time would be required to enable customers to make new arrangements and to settle their arrangements with their existing supplier. Equally the new supplier would need to make arrangements to receive the customers in an orderly manner. Whilst a longer period may give rise to greater financial risks in some, but not all, circumstances it is likely to enable a more orderly process to be followed.

It is also important that events of default triggering the effective termination of service agreements within the industry are defined in common across all such agreements. Differences between the agreements will wrongly incentivise a supplier in financial difficulties to meet firstly its liabilities under the most restrictive contracts. In time, there would be a risk that each service provider, in order to incentivise payment first to itself, would outbid the others in making the termination provisions in its contracts more restrictive.

In summary therefore, supplier default has, since Vesting, been a ground of licence revocation. Such default was defined at Vesting to be a ground of revocation only when the debt incurred had reached a certain level and certain procedures to recover it (ie issue of a statutory demand) had been taken. The consequences of a supplier exiting the market in electricity extend beyond the creditors of that supplier. Given the impact on a range of parties, including customers, a forced exit should properly be at the decision of the Director who is in a position to take into account the interests of all relevant parties.

In these circumstances OFFER is concerned about any proposal which would in effect bring to an end a supplier's rights to supply its existing customers prior to licence revocation.

It is recognised that in some circumstances debts may be incurred by the defaulting supplier during the period leading up to licence revocation and customers making new arrangements which may in practice not be recoverable. The likely extent of this risk is not readily identifiable. At present, however, it appears likely that the overwhelming majority of supply from 1998 will be undertaken by PESs, either within their own area or as second tier suppliers. Other major suppliers are likely to include the major generators and Centrica. Whilst no company is risk free, most concerns have focused on small scale suppliers. However, the number and impact of small scale independent suppliers seems likely to be limited at least in the medium term. Nevertheless, the risk of default cannot be eradicated. A mechanism needs to be identified which shares these risks equitably.

One proposal put forward is that a bonding arrangement, similar to that operated in the travel industry by ABTA, could be instituted. In its simplest form this might work as follows.

- All parties are obliged - by virtue of common industry contracts such as the Pooling & Settlement Agreement, the Master Registration Agreement or Use of System Agreements - to contribute to a bond.

- The contributions made are commensurate with the market share of the contributors.

- The bond monies are held in trust, to be paid after an event of licence revocation to certain industry creditors of a supplier in default who have (after taking all reasonable steps) been unable to recover sums owing to them.

- The sums recoverable by creditors would be those for services provided after the expiry of security cover and before licence revocation, together with sums attributable to customers who had failed to change supplier by the time of revocation.

Such an arrangement would raise a number of subsidiary issues. What should be the size of any bond? The obligation to contribute to it should not in itself become an onerous one. It must, however, be capable of covering a reasonable level of service provision for one supplier over a period of at least one month. What implications would a bond have for the appropriate level of security cover? The higher the level of security provided by individual suppliers, the less money would need to be available to meet debts through the bonding scheme. Who should maintain the bond? Instead of contributing in advance to a bond, should monies be collected after an event of revocation when the extent of the debt is known? Would this risk the non-collection of any of those monies?

In the short term, in the context of the PSA, much of the effect of a bond could be secured by extending to all suppliers the present 28 day risk sharing provision that applies only to PESs.

Some further steps are also appropriate to protect customers and other industry parties. Where a supplier has defaulted on key industry agreements it would be appropriate to limit the exposure of customers and others in the industry by restricting that supplier from registering any new customers. This can be achieved through provisions in the Master Registration Agreement.

In addition in extreme cases, for example involving fraud, it will be appropriate to alert customers about the position prior to the formal licence revocation procedure. The Director has powers under the Act to give information and advice to customers. This could be used to notify customers of any problems and advise them of the steps that they should take. They might include arranging for a new supplier at the earliest

opportunity. Again the decisions could be taken on a case by case basis taking fully into account the circumstances of the case and the interests of customers and industry parties.

Conclusions

The risk of suppliers defaulting on industry agreements whilst arguably small cannot be eradicated.

Should such an event occur it will inevitably lead to difficulties for other industry parties and for that supplier's customers. The objective is to minimise these difficulties taking into account the extent of the risks involved and the impact on customers and competition of the measures adopted.

The provisions for licence revocation make clear that the termination of a licence is not a step to be taken lightly. There is benefit for both customers and suppliers in knowing that only in serious and exceptional circumstances will third parties disrupt the contractual arrangements they have agreed. The time required to revoke licences and the discretion provided to the Director as to whether or not to take that step is an important safeguard for suppliers and customers. It enables each case to be treated on its merits and gives flexibility as to how the difficulties that have arisen should best be resolved. It also provides an opportunity for the industry, OFFER and customers to finalise arrangements appropriate to the circumstances to facilitate any change of supplier if that is required.

Whilst the time involved in licence revocation may give rise to financial losses, this risk needs to be set against the adverse consequences of any early steps and automatic transfer of customers from a supplier in default.

In the event of licence revocation the licence conditions provide for a mechanism by which customers can be alerted and encouraged to make arrangements. In extreme cases, customer notification could occur at an earlier date. The alternative approach, which has been canvassed in previous consultations, of including provisions for automatic transfer in all customer contracts appears unwieldy and potentially unreliable in practice. More significantly, its likely effect on competition and customer confidence are detriments likely to outweigh any practical benefits. It would however be desirable for the Director to have powers in such cases to deem contracts with new suppliers in order to smooth the process of transfer. However, this can only be provided by changes to the Electricity Act. OFFER would welcome such a change.

The present provisions in the Pooling and Settlement Agreement on security cover and default are being reconsidered as are the arrangements in the new Master Registration Agreement and revised use of system agreements. The appropriateness of a continuing distinction between PES and other suppliers should be considered. More generally OFFER sees advantage in an industry wide bonding arrangements which would recompense service providers if reasonable steps to recover outstanding debts had been unsuccessful. It might also provide a fund to recompense suppliers who had incurred significant unrecoverable additional costs in making arrangements with the customers

of the defaulting supplier. Submissions are welcomed from recipients of this paper as to the general principle of a bonding arrangement. Detailed comments are also invited in relation to the scope, implementation or any other matter concerning the detail of such an arrangement. Subject to the views expressed in response to this paper, OFFER will work with industry representatives to define in more detail the requirements for such a bonding arrangement.

To minimise the impact on customers and other industry parties it would seem appropriate to provide through the Master Registration Agreement that a supplier in default of settlement or use of system agreements (or where the Director has issued a notice of intention to revoke the supplier's licence) may not register any new customers.

Views are invited on the points made in this paper and in particular the requirements of a bonding arrangements. Comments should be sent to

Mrs Hilary Goldsmith
Supply Competition
Office of Electricity Regulation
Hagley House
Hagley Road
Birmingham B 16 8QG

by Monday 9 February 1998.

Unless respondents indicate clearly that they would prefer their response to remain confidential, OFFER will place copies of responses in the library for public inspection

ANNEX A

Schedule 2. Terms as to revocation

I. The Secretary of State may at any time revoke this Licence by not less than 30 days' notice in writing to the Licensee:

A. if the Licensee agrees in writing with the Secretary of State that this Licence should be revoked;

B. if any amount payable under Condition 29 is unpaid 30 days after it has become due and remains unpaid for a period of 14 days after the Secretary of State has given the Licensee notice that the payment is overdue. Provided that no such notice shall be given earlier than the sixteenth day after the day on which the amount payable became due;

C. if the Licensee fails to comply with a final order (within the meaning of Section 25 of the Act) or with a provisional order (within the meaning of that section) which has been confirmed under that section and (in either case) such failure is not rectified to the satisfaction of the Secretary of State within three months after the Secretary of State has given notice of such failure to the Licensee. Provided that no such notice shall be given by the Secretary of State before the expiration of the period within which an application under Section 27 of the Act could be made questioning the validity of the final or provisional order or before the proceedings relating to any such application are finally determined;

D. if the Licensee fails to comply with any order made by the Secretary of State under Section 56, 73, 74 or 89 of the Fair Trading Act 1973 or under Section 10(2)(a) of the Competition Act 1980;

E. if the Licensee ceases to carry on its business as a public electricity supplier:

F. if the Licensee:

1. is unable to pay its debts (within the meaning of Section 123(l) or (2) of the Insolvency Act 1986, but subject to paragraph 2 of this Schedule) or any voluntary arrangement is proposed in relation to it under Section 1 of that Act or if it enters into any scheme of arrangement (other than for the purpose of reconstruction or amalgamation upon terms and within such period as may

previously have been approved in writing by the Secretary of State);

2. has a receiver (which expression shall include an administrative receiver within the meaning of Section 29 of the Insolvency Act 1986) of the whole or any material part of its assets or undertaking appointed;

3. has an administration order under Section 8 of the Insolvency Act 1986 made in relation to it;

4. passes any resolution for winding-up other than a resolution previously approved in writing by the Secretary of State; or

5. becomes subject to an order by the High court for winding-up; or

G. if the Licensee is convicted of having committed an offence under Section 59 of the Act in making its application for this Licence.

II. For the purposes of paragraph l(f)(i) of this Schedule Section 123(l)(a) of the Insolvency Act 1986 shall have effect as if for "£750" there was substituted "£250,OOO" or such higher figure as the Director may from time to time determine by notice in writing to the Secretary of State and the Licensee.

III. The Licensee shall not be deemed to be unable to pay its debts for the purposes of paragraph l(f)(i) of this Schedule if any such demand as is mentioned in Section 123(l)(a) of the Insolvency Act 1986 is being contested in good faith by the Licensee with recourse to all appropriate measures and procedures or if any such demand is satisfied before the expiration of such period as may be stated in any notice given by the Secretary of State under paragraph 1 of the Schedule.

IV. The provisions of Section 109 of the Act shall apply for the purposes of the service of any notice under this Schedule.

ANNEX B

Condition 7A. Arrangements for informing customers on revocation of Licence

I. The Licensee shall comply with a direction from the Director in the following terms where the Director:

A. is, or is aware that the Secretary of State is, about to revoke a Licence granted to another Electricity Supplier to supply electricity (in this Condition known as the "First Supplier"); and

B. considers that the Licensee is able to supply electricity to the customers of the First Supplier without significantly prejudicing the supplies of electricity which the Licensee makes or is contracted to make.

II. The Director shall only issue a direction in accordance with paragraph 1 when the Secretary of State or, as the case may be, the Director has served the First Supplier with a notice that he is revoking the First Supplier's Licence to supply electricity in accordance with the terms of the First Supplier's Licence, or such earlier date as the Director may agree with the First Supplier.

III. A direction issued in accordance with paragraph 1 shall require that the Licensee shall, within the period specified by the Director, send a written notice in a form approved by the Director to each of the persons or premises specified or described in the direction:

A. informing the customer in question that, notwithstanding any contract he may have with the First Supplier, the First Supplier is no longer supplying him with electricity and has not done so since the revocation took effect or, where the notice has been sent before the revocation has taken effect, will be no longer supplying him with electricity when it takes effect;

B. informing the customer that the customer must from the moment the revocation takes effect enter into a new contract for supply with another Electricity Supplier of the customer's choice, and that he is free to request a supply from the Licensee; and

C. setting out the terms upon which the Licensee is prepared to supply electricity if requested.