Renewables Obligation – Mutualisation

24 October 2018

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What we will cover

• The recent background of supplier failure
• Where the shortfall presently sits
• The mutualisation process and timetable
• Materiality of possible shortfall and its cost to the supplier community
• Possible impacts on recycling values
Recent supplier failure

- 2018 has seen a high number of supplier failures

<table>
<thead>
<tr>
<th>Supplier</th>
<th>Date</th>
<th>Elec accounts (est)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Future Energy</td>
<td>Jan 18</td>
<td>10,000</td>
</tr>
<tr>
<td>GEN4U</td>
<td>July 18</td>
<td>1,000</td>
</tr>
<tr>
<td>National Gas and Power</td>
<td>July 18</td>
<td>80 (non-dom)</td>
</tr>
<tr>
<td>Iresa</td>
<td>July 18</td>
<td>95,000</td>
</tr>
<tr>
<td>Ephase</td>
<td>Aug 18</td>
<td>20</td>
</tr>
<tr>
<td>USIO</td>
<td>Oct 18</td>
<td>7,000</td>
</tr>
<tr>
<td>Snowdrop</td>
<td>Oct 18</td>
<td>6,000</td>
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- Rising wholesale prices, price spikes (Beast from the East), and now entering RO payment deadline (and PAR1)
Where is the RO buy-out fund shortfall?

• Assuming suppliers that exited the market this year do not meet their RO we estimate the buy-out fund has a shortfall of around £10.2mn

• Ofgem’s note on Monday stated that there was a shortfall of £102,903,066.44 in the buy-out
  o 34 suppliers have to pay into the late payment fund
  o non-compliant suppliers have until 31 October to make payments into the late payment fund
  o not clear from Ofgem if the shortfall amount was at the end of the buy-out fund deadline (31 August) or Monday (22 October)

• On this basis the worst-case scenario is the shortfall remains at £103mn, with best-case scenario being £10.2mn
RO Mutualisation

• Following failure of TXU (and Maverick Energy) in 2002 the notion of a introducing a mechanism to cover a shortfall in the buy-out fund gained traction

• Energy Act 2004 gave Secretary of State the power to require suppliers to make payments to Ofgem in the event of a shortfall in the buy-out fund

• Other approaches considered included:
  o do nothing (damages confidence in RO)
  o securitisation (deemed too costly)
  o shorten obligation period to six-months (potential cash flow issues for small generators, market entry barriers, added administration complexities/ costs)
RO Mutualisation

• Following advice (including from Cornwall Insight) and consultation the ‘Mutualisation Fund’ was introduced whereby electricity suppliers (excluding the defaulting supplier) contribute to make up the shortfall
  o applies to all suppliers irrespective of whether or not they are due money from the buy-out fund
  o note: only applies to GB buy-out and not NI buy-out fund
  o also enabled late payment process – which includes interest payment @ 5% above BoE base rate on first day of the late payment period (i.e. 1 September)

• Mutualisation fund is then distributed in similar way as the buy-out fund for that obligation period

• Detail contained in the RO Order 2005 (and updated in RO Order 2015 and RO (Scotland) Order 2009)
Overview of mutualisation process

Suppliers meet RO by redeeming Rocs and/or paying into buy-out fund

Buy-out Fund recycled to suppliers that redeemed Rocs

Is market ‘whole’?

Late Payment fund accrues payments @ 5% + BoE base rate (i.e. 5.75%)

Is mutualisation triggered?

Late Payment fund recycled to suppliers that redeemed Rocs

Is market ‘whole’?

Mutualisation fund recycled to suppliers that redeemed Rocs

Mutualisation fund recovers all of shortfall from suppliers

Shortfall in recycle payment
## Timetable

<table>
<thead>
<tr>
<th>Date</th>
<th>Activity</th>
</tr>
</thead>
<tbody>
<tr>
<td>&gt; 1 Jul</td>
<td>Ofgem confirms total UK RO</td>
</tr>
<tr>
<td>31 Aug</td>
<td>Suppliers make buy-out payments</td>
</tr>
<tr>
<td>1 Sep</td>
<td>Suppliers redeem Rocs</td>
</tr>
<tr>
<td>&gt; 1 Sep</td>
<td>Ofgem informs any supplier that has not met RO</td>
</tr>
<tr>
<td>1 Sep to 31 Oct</td>
<td>Suppliers make pay into late payment fund (where necessary)</td>
</tr>
<tr>
<td>&gt; 31 Oct</td>
<td>Ofgem informs suppliers of shortfall in buy-out fund and amount each supplier is liable for</td>
</tr>
<tr>
<td>By 1 November</td>
<td>Ofgem redistributes buy-out fund (16 Oct) and informs market of recycle proportions to each supplier (22 Oct)</td>
</tr>
<tr>
<td>&lt; 1 Jan</td>
<td>Ofgem redistributes late payment fund and informs market of recycle proportions to each supplier</td>
</tr>
<tr>
<td>&lt; Sep (yr+1)</td>
<td>Suppliers make first 25% instalment to mutualisation fund</td>
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<tr>
<td>By 1 Nov (yr+1)</td>
<td>Ofgem redistributes first quarter of mutualisation fund</td>
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How is mutualisation invoked?

1. ‘As soon as reasonably practical’ after Late Payment fund period. Ofgem determines level of shortfall [31 October]

2. Is shortfall > £16.94mn? [Sum of E&W and Scots trigger = £15.4mn + £1.54mn]

3. Mutualisation fund amount = Shortfall – [Shortfall X (Rocs redeemed by non-compliant supplier/ Total Rocs redeemed by all suppliers)] i.e. reduce Mutualisation fund by fraction of Rocs submitted by non-complaint supplier(s)

4. Mutualisation fund amount is capped (‘ceiling’) at £200mn (2005 money inflated by RPI annually)
   For 2017-18 = £302mn [Sum of E&W and Scots ceiling = £275mn + £28mn]
Why mutualisation trigger and cap?

- **Rationale for not mutualising all shortfall**
  
  Only shortfalls over a certain level will trigger the mutualisation process because very small shortfalls will not affect certificate prices and the expenses of the mutualisation process will outweigh the amounts recovered.
  
  *Source: Explanatory Note to RO Order 2005*

- **Rationale for ceiling at which a shortfall is not recovered**
  
  Mutualisation is potentially an expensive process for suppliers and much of the cost will be passed onto electricity consumers. To prevent electricity bills rising significantly and to avoid the possibility of pushing more suppliers into insolvency, a cap has been set on the amount that will be recovered through mutualisation.
  
  *Source: Explanatory Note to RO Order 2005*
Recovery of Mutualisation fund

- Individual supplier’s level of Mutualisation fund payment is linked to its market share
  - this the same as the overall RO share (of remaining suppliers) the supplier incurs in that Compliance Period
  - i.e. if supplier has 10% market share for purposes of RO (ignoring the failed suppliers) then it will contribute 10% towards mutualisation fund

- Note: A supplier who only partially meets their RO is still liable for making payments to Mutualisation fund
  - i.e. prevents a supplier complying with most of its RO but leaving a small part outstanding so as to fall outside the class of suppliers required to make mutualisation payments
Mutualisation payment timescales

- Suppliers make mutualisation payments in four equal instalments
- First payment in September following the compliance period where the relevant shortfall occurred
  - every three months thereafter

<table>
<thead>
<tr>
<th>Payment deadline</th>
<th>Proportion</th>
<th>Redistribution deadline</th>
</tr>
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<tbody>
<tr>
<td>Before 1 Sep</td>
<td>25%</td>
<td>Before 1 Nov</td>
</tr>
<tr>
<td>Before 1 Dec</td>
<td>25%</td>
<td>Before 1 Feb</td>
</tr>
<tr>
<td>Before 1 Mar</td>
<td>25%</td>
<td>Before 1 May</td>
</tr>
<tr>
<td>Before 1 Jun</td>
<td>25%</td>
<td>Before 1 Aug</td>
</tr>
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Receiving Mutualisation Fund recycle payments

- Very similar to conventional process for paying buy-out fund
  - e.g. pro-rated on fraction of Rocs submitted during the Compliance Period (year)...
  - ...but mutualisation fund payments **not** paid out to any suppliers that did not comply **in full** with their RO during the year
  - therefore Rocs presented by a ‘non-compliant’ supplier are disregarded for the purposes of assessing how much each compliant supplier should receive

**Example:**
Shortfall of £100 and therefore mutualisation fund of £100. Suppliers A and B redeem 10 Rocs each and are ‘compliant’ Supplier C redeems 10 Roc but is a non-compliant – therefore not entitled mutualisation fund payments.
If mutualisation fund were divided among compliant suppliers in same proportion that their Rocs relate to total number of Rocs, Suppliers A & B would each receive 1/3 of the fund, but 1/3 of the fund would be undistributed
Hence disregarding Rocs produced by Supplier C, means Suppliers A and B each receive ½ of mutualisation fund instead
Mutualisation trigger (GB)

- Trigger (GB): £mn
- Trigger @ % of RO cost

<table>
<thead>
<tr>
<th>Year</th>
<th>Trigger (GB): £mn</th>
<th>Trigger @ % of RO cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010-11</td>
<td>£12</td>
<td>0.0%</td>
</tr>
<tr>
<td>2011-12</td>
<td>£14</td>
<td>0.1%</td>
</tr>
<tr>
<td>2012-13</td>
<td>£16</td>
<td>0.3%</td>
</tr>
<tr>
<td>2013-14</td>
<td>£18</td>
<td>0.5%</td>
</tr>
<tr>
<td>2014-15</td>
<td>£18</td>
<td>0.7%</td>
</tr>
<tr>
<td>2015-16</td>
<td>£18</td>
<td>0.9%</td>
</tr>
<tr>
<td>2016-17</td>
<td>£18</td>
<td>1.0%</td>
</tr>
<tr>
<td>2017-18</td>
<td>£18</td>
<td>0.9%</td>
</tr>
<tr>
<td>2018-19</td>
<td>£18</td>
<td>0.8%</td>
</tr>
</tbody>
</table>
Mutualisation ceiling (GB)
What can we infer?

- Figures from Ofgem’s note on Monday show almost £5 in £6 of buy-out has been paid.
- The note only shows those suppliers that met (at least in part) their RO via redeeming Rocs.
  - Therefore some suppliers not on its list may have met their RO entirely through the buy-out—tends to be a newer supplier strategy.
- Our analysis suggests that shortfall (as reported by Ofgem) is largely made up (in number) by smaller suppliers, but some notable medium suppliers too.
  - This could be that some suppliers see the late payment fund interest as being a cheaper form of loan (5.75% annualised).
  - More likely that a supplier that did not redeem Rocs will not have made buy-out payments.
What can we infer?

• It is not possible to definitively know if suppliers paying into the Late Payment fund are doing so for commercial reasons or because of distress
  o ...but this is the highest absolute level of shortfall since TXU in 2002 (£23mn)
• Shortfall amount from suppliers that have exited the market suggests 60% towards mutualisation
  o suppliers that redeem Rocs receive recycle sums (with delay)
  o all suppliers bear some of the cost and in the round—there is no additional cost to industry but some suppliers will gain at the expense of others
• Should also bear in mind that next year’s RO compliance will also have to consider this years supplier exits...
What can we infer?

If supplier exits equate to about 120k household accounts this could trigger mutualisation.
What does this mean for recycle values?

- Ofgem confirmed the initial recycle value at £5.42/Roc
- With late payment fund (£103mn) minus £10.3mn from recent supplier exits this suggest a max of £93.6mn to be recycled
  - This will add £0.91/Roc onto the final recycle value, bringing it to £6.33/Roc...
  - ...but revenues will only flow in late 2019/ early 2020
  - if mutualisation is not triggered (e.g. shortfall reduces from £103mn to below £17mn) this equates to a loss of recycle of about £0.17/Roc
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