

## Review of the 'Ring Fence' Conditions in Network Operator Licences

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**Target audience:** Network companies, finance providers, energy suppliers, customers, customer representatives and other interested parties

### Overview:

The licences of gas and electricity transmission and distribution companies include conditions – the 'ring fence' conditions - designed to secure that their assets, cash flows and other financial resources are applied to meet the needs of the regulated company. These are aimed at protecting consumers in the event of financial distress or failure in an energy network company whatever the cause. The existing ring fence conditions were developed and introduced during the 1990s.

We have recently undertaken a thorough review and stress testing of the existing ring fence conditions and have identified a number of changes that we think would provide greater protection for consumers. This document sets out, for consultation, a proposed set of incremental changes to ensure that the arrangements are as robust as possible. We welcome views on these proposals.

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## Context

Ofgem's principal objective is to protect the interests of existing and future consumers.

Should the financial position of a network company deteriorate, that company may struggle to continue to invest appropriately, maintain its network and deliver acceptable network performance, reliability and customer service. In the absence of mitigating measures, if those conditions prevail over time, they may threaten the security and reliability of that network company's customers' energy supplies.

The legislative and regulatory framework in place for Britain's energy networks is designed to reduce the risk of any financial distress of network operators harming consumers. This framework includes a suite of arrangements designed to manage the risks to and impact of deteriorating financial health of an energy network company on consumers.

Importantly, they are not designed to remove the threat of bankruptcy. 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.

Ofgem has arrangements in place to monitor the financial health of network companies and to respond in the event that one or more of those companies faces deteriorating financial health. The ring fence conditions contained in NWO licences are an important part of the regulatory regime in this regard, aimed at protecting consumers in the event of financial distress in an energy network company as a result of that company's own action or inaction. They do this by placing constraints on the operations of licensees to ensure that resources are available for their regulated activities and that any restructuring or administration process is orderly.

The primary responsibility for the financial integrity of a network company lies with that company's management and shareholders. We expect companies to act responsibly and to inform Ofgem at the earliest stage possible of any potential or actual financial distress. The earlier that a case of financial distress can be identified, the more response options we have available that may help to mitigate and/or contain the situation.

In light of recent financial market conditions, we have reviewed and stress tested these arrangements, and have identified a number of potential issues. We are proposing a set of incremental changes to the ring fence conditions to improve their effectiveness and address concerns and weaknesses we have identified. We welcome views of stakeholders on these proposals.

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## Associated documents

- a. [Standard conditions of the electricity transmission licence](#)  
<http://epr.ofgem.gov.uk/index.php?pk=doc532088>
- b. [Standard conditions of the electricity distribution licence](#)  
<http://epr.ofgem.gov.uk/index.php?pk=doc523991>
- c. [Standard conditions of the gas transporters licence](#)  
<http://epr.ofgem.gov.uk/index.php?pk=doc527028>
- d. [Standard special conditions of the gas transporters licence](#)  
<http://epr.ofgem.gov.uk/index.php?pk=folder132383>
- e. [Ofgem decision document: Arrangements for responding in the event that an energy network company experiences deteriorating financial health](#)  
<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=259&refer=Networks/Policy>
- f. [Energy Act 2004 - Special administration regime for energy licensees](#)  
[http://www.opsi.gov.uk/acts/acts2004/ukpga\\_20040020\\_en\\_15#pt3-ch3](http://www.opsi.gov.uk/acts/acts2004/ukpga_20040020_en_15#pt3-ch3)
- g. [Electricity Distribution Licences: Initial Proposals on Standard Conditions for the Financial 'Ring-fence' - A Consultation Paper \(December 1999\)](#)  
<http://www.ofgem.gov.uk/Licensing/Archive/Electricity%20Distribution%20Licences%2016%2012.pdf>
- h. [CEPA report October 2009: Assessment of Ofgem's Financial Ring Fence Conditions](#)  
[see Associated documents table under this document on the Ofgem website]
- i. [DECC documentation on downstream gas and electricity resilience](#)  
[http://www.decc.gov.uk/en/content/cms/what\\_we\\_do/uk\\_supply/resilience/gas\\_electric/gas\\_electric.aspx](http://www.decc.gov.uk/en/content/cms/what_we_do/uk_supply/resilience/gas_electric/gas_electric.aspx)

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## Summary

If the financial position of an energy network operator (NWO)<sup>1</sup> deteriorates, that company may struggle to continue to invest appropriately, to maintain its network and deliver acceptable network performance and customer service. In the absence of mitigating measures, if those conditions prevail over time, they may threaten the security and reliability of that network company's customers' energy supplies.

The legislative and regulatory framework is designed to ensure that consumers do not suffer lower network reliability or service quality as a result of a failure by an NWO to invest sufficiently, and that consumer bills do not rise to fund investment that consumers have already funded but that the company has failed to deliver.

The framework is not designed to remove the threat of bankruptcy. 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 and reinforcing these incentives. They also encourage companies to innovate financially and to take appropriate risks.

Although we have a legal duty to have regard to the ability of licensees to finance their regulated activities, primary responsibility for the financial health of NWOs lies firmly with their managers, directors and owners. We have made clear that we would not 'bail out' an NWO that has encountered financial difficulties as a result of inefficiencies and the actions (or inaction) of its own management or because of financial structuring choices made at corporate group level.

NWO licences contain a suite of conditions – collectively referred to as the 'regulatory ring fence' - designed to secure that the assets, cash flows and other financial resources are applied to meet the needs of the regulated company and that any restructuring or administration process is orderly. They do this by placing constraints on the operations of licensees to ensure that resources are available for their regulated activities and that any restructuring or administration process is orderly.

The ring fence forms an important part of our regulatory approach to managing the risk of financial distress. The regime has these broad objectives:

- Preventing the onset of financial distress by imposing a range of regulatory requirements to back up the corporate governance arrangements put in place by the managers and owners of NWOs,
- Providing warning signals when symptoms of financial distress appear or potential threats are identified,
- Mitigating the severity and impact of financial distress factors should they arise and reducing any 'chain reaction' of adverse financial events, and

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<sup>1</sup> 'NWO', 'NWO company' and 'licensee' all refer to the corporate person (i.e. company) that holds the relevant electricity transmission, electricity distribution or gas transporters licence.

- Facilitating price control re-opener measures or the special administration process where these are warranted.

These measures are backed up by contingency provisions in legislation to ensure continuity of energy supplies to consumers in extreme circumstances (see associated document 'i').

During 2009, we reviewed our procedures for managing financial distress and carried out a simulation exercise to test their effectiveness. As part of that process we have reviewed the ring fence licence conditions and identified a number of issues and potential improvements.

We still think that the managers and owners of NWOs are best placed to decide on the most efficient structural and financial arrangements for their businesses. We do not consider it would be in the interest of consumers or consistent with our duties to intervene in the detail of these management choices. However, this freedom has, over time, led to ever more complex business structures, which often involve significant operational and financial inter-dependence between entities and companies (including licensees) within corporate groups. The ring fence arrangements need to address any issues raised by such structures.

This document sets out the options for changes to the ring fence conditions to address the issues identified. Our preference is for a limited range of focussed enhancements backed up by a clear regulatory standpoint on the duties and responsibilities of NWO company directors. Combined with effective regulatory compliance, special administration and price control reopener procedures, we consider this approach would improve the effectiveness of the ring fence without undermining the incentives and disciplines provided by capital markets or imposing disproportionate costs or regulatory burden on the companies. We also set out and discuss two alternative approaches: a less intrusive approach and a more intrusive one.

A more intrusive approach would involve tightening or adding to the existing ring fence conditions, potentially combined with additional formal reporting requirements and greater monitoring by Ofgem. A less intrusive approach would involve removing some of the existing ring fence conditions and placing greater reliance on an enhanced certification of resource adequacy and sanctions on directors. This latter approach would also place more reliance on the use of price control re-openers and special administration as appropriate to the circumstances.

We are mindful of the importance that finance providers attach to the ring fence and are seeking views and feedback from this sector together with NWOs, customer representatives and other interested stakeholders.

Depending on the responses we receive to this consultation, we expect to carry out a further consultation on specific licence modification proposals, recognising that several types of licence held by NWOs of different types and sizes would be affected.

## 1. Introduction and objectives

**Chapter summary:** This chapter sets out the background to and purpose of our review of the ring fence conditions.

### Question box

Question 1: Do you think we have identified the relevant objectives in our review of the ring fence? If not what other objectives should we consider?

## Introduction

1.1. Ofgem's principal objective is to protect the interests of existing and future consumers. We do this by promoting effective competition wherever appropriate and through regulation where necessary. In carrying out its duties Ofgem is required to have regard to a number of factors including the need to secure that licence holders are able to finance their regulated activities.

1.2. Energy network companies are natural monopolies and Ofgem sets price controls that ensure that efficient licensees can earn a fair return after capital and operating costs whilst limiting the amounts that customers can be charged through their energy bills. All of the network licensees in Great Britain are part of larger corporate groups whose policies consequently impinge on the financing of the regulated businesses.

1.3. 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. Ofgem has arrangements in place to monitor the financial health of network companies and to respond in the event that one or more of those companies faces deteriorating financial health.

1.4. These arrangements include a suite of six conditions – the 'regulatory ring fence' – contained in the licences held by energy network operators (NWOs)<sup>2</sup> that are designed to secure that their assets, cash flows and other financial resources are applied to meet the needs of the regulated company and that any restructuring or administration process is orderly. They do this by placing constraints on the

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<sup>2</sup> In this document the terms 'NWO', 'NWO company' and 'licensee' all refer to the person (a corporate person i.e. company) that holds the relevant electricity transmission, electricity distribution or gas transporters licence. NWOs 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). They do not include interconnector licence holders.

operations of licensees to ensure that resources are available for their regulated activities and that any restructuring or administration process is orderly.

1.5. The ring fence conditions operate as part of a wider legislative and regulatory regime and within the framework of the price control charge restrictions which apply to NWOs<sup>3</sup>. Price controls are set as packages and usually last for five-year periods. We review the terms of each price control package before the relevant period expires. The nature of NWO price controls means that licensees can expect to receive relatively stable revenue streams, which makes them attractive to certain types of investor either through ownership or through direct lending or purchase of issued securities. As well as regulation by Ofgem and governance by their managers, NWO companies and the corporate groups of which they are members are also to some extent 'overseen' by the City, institutional investors, analysts and shareholders who influence management behaviour through various checks and control mechanisms.

1.6. Notwithstanding our duty to have regard to the ability of licensees to finance their regulated activities, primary responsibility for the financial health of NWOs lies firmly with their managers, directors and owners. We have made clear that we would not 'bail out' an NWO company that has encountered financial difficulties as a result of the actions (or inaction) of its own management or because of financial structuring choices made at corporate group level. 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.

1.7. 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 provisions under which companies can seek the re-opening of an existing price control to increase the revenues they are able to collect.

1.8. In light of recent global financial market conditions, in 2009 we reviewed our procedures for managing financial distress and carried out a 'war games' exercise to test their effectiveness.

1.9. We have separately published information on our approach to dealing with financial distress in NWO companies (see associated document 'e'). We have set out the ways in which we will manage and minimise the risk of financial distress and deal with episodes of varying severity which might nonetheless arise. We have

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<sup>3</sup> Independent network operators are subject to relative price controls that refer to the charging levels of the incumbent operator for the area concerned.

also taken steps to improve the way in which we monitor NWOs' financial positions and the arrangements we have in place to liaise with the Department of Energy and Climate Change (DECC) and other government departments when necessary.

1.10. As part of that process we have reviewed the ring fence licence conditions and considered ways in which they could be improved to address changing economic and operational risks.

1.11. This document sets out, for consultation, proposed amendments to the ring fence conditions together with an impact assessment.

1.12. We are mindful of the importance that finance providers attach to the ring fence and are seeking views and feedback from this sector together with NWOs, customer representatives and other interested stakeholders. We are particularly keen to minimise any risk of unintended consequences.

## **Overall objective**

1.13. The overall objective of our review of the ring fence conditions in NWO licences is to ensure that they are as robust as possible in light of lessons learned from the recent financial crisis. At the same time we want to minimise any impact on the freedom of NWO management to organise and finance their businesses efficiently and in a way which provides the best levels of service to their customers.

1.14. The intention of reviewing the existing arrangements is not therefore to eliminate the possibility of financial failure of a network company.

1.15. In considering the nature of any changes to the ring fence provisions we also need to consider the relationship between the likelihood of a financial distress event occurring and the impact that a given event would have. Conventionally the level of risk is expressed as the product of these two factors. In respect of NWOs the factors most closely align to the relative sizes of NWO businesses with the most significant differential being between the incumbent NWOs and the new independent entrants to the market (IGTs and IDNOs<sup>4</sup>). It is also appropriate to consider the possibility that more than one NWO could experience financial distress at the same time, although the risk of 'contagion' seen in the banking sector during the recent financial crisis is small. These factors are relevant to consideration of the level of regulatory intervention that should be incorporated into the ring fence arrangements given impact and resourcing implications.

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<sup>4</sup> Independent gas transporters and independent (electricity) distribution network operators

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## 2. The existing ring fence and issues arising

**Chapter summary:** This chapter summarises the existing ring fence licence conditions and sets out the concerns identified.

### Question box

Question 1: Have we identified the key risks associated with any limitations of the existing ring fence conditions?

### The existing ring fence arrangements

2.1. The ring fence forms an important part of our regulatory approach to managing the risk of financial distress, which is one of 'defence in depth'. The regime has the following broad objectives:

- Preventing the onset of financial distress by imposing a range of regulatory requirements to back up the corporate governance arrangements put in place by the managers and owners of NWOs,
- Providing warning signals when symptoms of financial distress appear or potential threats are identified,
- Mitigating the severity and impact of financial distress factors should they arise and reducing any 'chain reaction' of adverse financial events, and
- Facilitating price control re-opener measures or the special administration process where these are warranted.

2.2. The progressive structure of this protection is important for consumers because it should minimise any adverse cost or network efficiency effects that could result from financial distress in the short or longer term.

2.3. The ring fence consists of six licence conditions, which were devised and introduced from 1995 onwards. These six conditions are not grouped or explicitly labelled under the title of 'regulatory ring fence conditions' in licences and the numbering of the conditions and some of the detailed provisions and applicability vary between licence types. However, in each case they are intended to curtail abuse of the licensee's regulated status or improper diversion of resources which have been funded by energy consumers.

2.4. A number of the conditions allow the Authority to give consent to actions or positions which would otherwise be prohibited, allowing a degree of flexibility. However, consents are only given where doing so is in the interest of consumers and consistent with Ofgem's other duties. This will usually mean either that the consent does not involve an increase in the level of financial or operational risk or, if there is an increase in risk, that it is outweighed by the benefits of giving the consent and can be adequately managed. On rare occasions, for example during industry restructuring phases, the ring fence has been 'extended' by allowing licensees to

enter into financial arrangements with related parties. This has been subject to the giving of legally enforceable undertakings by those parties equivalent to the relevant licence provisions. The flexibility afforded by the consent mechanisms would also be a useful tool in dealing with circumstances where enforcement in respect of a breach of conditions could cause a chain reaction, itself leading to financial distress.

2.5. The ring fence conditions are designed to work in conjunction with each other (in most cases the restrictions are additive) and with other licence conditions. For example, the ring fence stipulation that any loans to related parties must be on normal commercial terms<sup>5</sup> works in tandem with other licence conditions (and legal requirements under competition and companies law), which prohibit the giving of cross subsidies to related parties. In making any changes to the conditions we want to retain or improve this synergy.

2.6. The six licence conditions that form the ring fence are:

- Availability of resource requirements,
- Restriction on the disposal of relevant assets,
- Requirement to hold an investment grade credit rating,
- Restriction on indebtedness and transfer of funds,
- Restriction on activity and financial ring fencing, and
- Ultimate controller undertaking.

2.7. The conditions and intended objectives are summarised in figure 2.1 below. Greater elaboration is provided in Appendix 2. Reference should also be made to the full legal text of the conditions which are included in the list of associated documents<sup>6</sup>.

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<sup>5</sup> See 'Indebtedness' condition references in Appendix 2

<sup>6</sup> Some modifications to the standard conditions of the electricity distribution licence will be made in March 2010 as part of the DPCR5 process, but these will not affect the ring fence provisions.

*Figure 2.1: Summary of ring fence licence conditions*

| Licence condition   | Requirement on NWO  | Purpose   |
|---|---|---|
| <b>Availability of resources</b>                          | <ul style="list-style-type: none"> <li>• Ensure it has sufficient resources to carry on its licensed activities and submit a certificate to the Authority annually, supported by the licensee's external auditors, confirming availability of financial resources and referring to factors considered.</li> <li>• Not make or pay any dividend that would cause it to be in breach of its financial ring fence conditions at any future time.</li> <li>• Report adverse circumstances at any time.</li> </ul> | <ul style="list-style-type: none"> <li>• Ensures that a protected energy company always has at its disposal the resources to maintain and develop an efficient, economic and coordinated system.</li> </ul>   |
| <b>Disposal of relevant assets</b>                        | <ul style="list-style-type: none"> <li>• Provide two months written notice to Ofgem of any proposed disposal, relinquishment of operational control, or granting of security over, any assets forming part of its network (with certain exemptions).</li> </ul>   | <ul style="list-style-type: none"> <li>• Prevents licensees from relinquishing control of any asset that may be critical to the operation of their network without agreement from Ofgem.</li> </ul>   |
| <b>Credit rating</b>                                      | <ul style="list-style-type: none"> <li>• Maintain an investment grade credit rating<sup>7</sup> i.e. not less than (i) BBB- by Standard &amp; Poor's; (ii) Baa3 by Moody's; or (iii) BBB- by Fitch Ratings</li> </ul>   | <ul style="list-style-type: none"> <li>• Gives some comfort 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.</li> </ul> |
| <b>Restriction on activity and financial ring-fencing</b> | <ul style="list-style-type: none"> <li>• Not conduct any activities other than those of its core business, subject to certain exceptions and specific limitations relating to turnover and investment levels</li> </ul>   | <ul style="list-style-type: none"> <li>• Guards against 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.</li> </ul>                                    |

<sup>7</sup> IGTs and IDNOs too small to receive their own credit rating are permitted to obtain a 'keep-well' agreement from their parent instead. These agreements include commitments to provide all necessary funding and resources to ensure that the licensee can meet its obligations. If the parent does not itself have an investment grade credit rating the licensee must hold a sum equal to six months operating/asset replacement costs in escrow or an equivalent facility.

| Licence condition                      | Requirement on NWO   | Purpose  |
|--|--|--|
| <b>Indebtedness</b>                    | <ul style="list-style-type: none"> <li>• Not 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 with the consent of Ofgem.</li> <li>• Not enter into an agreement incorporating a cross-default obligation (with some exceptions) without consent from Ofgem.</li> </ul> | <ul style="list-style-type: none"> <li>• Ensures that a licensee only assumes liabilities relating to the conduct of its own business and activities and does not become exposed to risks at group level that may jeopardise its financial position outside of those activities.</li> <li>• Cash lock-up provisions should mean that the licensee conserves cash and other sources of value when its investment grade credit rating is jeopardised.</li> </ul> |
| <b>Ultimate controller undertaking</b> | <ul style="list-style-type: none"> <li>• Obtain an undertaking from its parent company and any other ultimate controllers that they will refrain from taking any action which may cause the licensee to breach its obligations under the Gas Act or the Electricity Act or its licence.</li> </ul>   | <ul style="list-style-type: none"> <li>• Prevents 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 also the other ring-fence conditions.</li> </ul>  |

## Ofgem concerns

2.8. A number of aspects of the regulatory ring fence have performed well. However, we have identified four key issues with the current arrangements that we think may put consumers at unnecessary risk of higher prices and / or reduced standards of service in the event of the financial distress of an NWO. These are set out below.

2.9. We have worked with Cambridge Economic Policy Associates Ltd (CEPA) to evaluate the ring fence using a scenario based approach. Their report is available on our website (see associated document 'h').

### Lack of focus on operational risks

2.10. Whilst the availability of resources condition requires NWOs to ensure that they have sufficient resources to carry out their licensed activities, the annual certification process only requires companies to certify that they have adequate access to financial resources. Consequently, a factor affecting non-financial resources would not be directly caught by the requirement to report subsequent adverse circumstances.

2.11. The increased use of contracting out by network companies suggests that operational risks may be significant. Indeed, a significant number of companies rely upon other group companies or external service providers to provide key services to the network licensee. There are a few where no activities are undertaken by the licensee, with all work carried out by a service provider.

2.12. The risk is of a situation where managers of a network business could be aware of serious resourcing issues and yet be fully compliant in providing a certificate stating a reasonable expectation of access to sufficient financial resources for the next 12 months. For example, there might be serious concerns about a vital service provision contract, information technology system or rapid loss of key technical staff.

### Limited early warning role

2.13. The adequacy of resources statement currently provides relatively little information to inform us of significant risks and the lack of focus on operational issues, particularly in respect of changes subsequent to the annual certification process mentioned above, limits the effectiveness of the ring fence as an early warning mechanism.

2.14. In addition, other elements of the ring-fence also have weaknesses in providing appropriate early warning.

2.15. The cash lock up can currently only be triggered by a downgrade in a licensee's credit rating to speculative grade or a negative warning by a credit rating agency.

2.16. Credit ratings are primarily intended to reflect the repayment risk associated with different classes of corporate debt and, although ratings are based on a wide range of information and analysis, there is no guarantee that downgrades will provide early warning of financial distress. Indeed, in the recent credit crises a number of institutions and instruments had investment grade ratings until shortly before financial failure. As a result, the cash lock up may not be triggered early enough to prevent cash and other assets leaving the network business.

### **Weaknesses in the indebtedness and transfer of funds restrictions**

2.17. The purpose of these restrictions is to ensure that in the event of financial distress an energy administrator would have access to the essential assets and funds necessary to ensure continuance of operations. We have already mentioned above concerns over the timeliness of the operation of the cash trigger.

2.18. Even where the cash lock up is triggered in a timely manner, it is still not clear whether there will be any cash to 'lock-up' in the licensee. This is because the cash attributable to the licensee may be 'banked' with a central corporate treasury, which may or may not be located in the UK. This tends to be for legitimate reasons of corporate efficiency, but it does mean that the licensee's own bank accounts may hold little cash at any given time. In addition, even where cash is held at the licensee level, there are legitimate ways in which the licensee could transfer funds to a parent while under the current lock up regime. For example, loans to NWOs from related undertakings are often 'repayable on demand' such that repayments might be treated as exempt from cash lock up stipulations.

2.19. NWOs are currently unable to use their operational assets as security for any indebtedness. However, there is no restriction over the ability of NWOs to use their trade debtors as security which could result in an energy administrator finding they have limited funds coming into the business which could result in a need for loans from the Government to maintain operations, the cost of which may ultimately need to be passed onto consumers.

2.20. In addition, there is presently no licence requirement for NWOs to keep up to date management information on key financial and operational resourcing issues in one place for ready reference in the event of financial or operational distress.

### **Weak sanctions on directors**

2.21. Ofgem is able to issue financial penalties against NWOs for breach of licence, including breach of conditions that are part of the financial ring fence. However, it is not clear that financial penalties against the company would act as a significant deterrent for directors who face pressure from their parent company during a period of deteriorating financial health.

2.22. At present, there is no licence requirement for NWOs to have any independent directors on their boards. The directors of the licensed entity are often managers

within a wider corporate group and may routinely work to implement objectives and strategies set by more senior corporate managers. None of the licensed entities are themselves listed companies. Consequently they are not subject to the Combined Code on Corporate Governance.

2.23. Although we have no reason to believe that existing licensee directors do not perform their duties in accordance with requirements of companies legislation, there could be circumstances where conflicts of interest could arise, for example where the wider corporate group is experiencing financial distress. In this context, it is worth reiterating that network personnel and operational facilities may in fact be managed by a related party of the licensee.

2.24. Independent non executive directors may be better placed to challenge any management decisions that prejudice the interests or conflict with the obligations of the particular company on whose board they sit, particularly at times of exigency. It is important to note from high profile corporate failures, however, that independent directors have not always been able to spot or prevent financial predicaments. Their influence should nonetheless enhance the overall efficacy of the ring fence regime.

### **Our findings regarding the existing ring fence conditions**

2.25. We think that the existing ring fence conditions have formed and continue to form an important part of the regulatory regime generally and of our safeguards against financial or operational distress in particular. It is, of course, impossible to know with certainty whether distress episodes would have occurred in the past if the ring fence conditions either did not exist or were less comprehensive. However, previous failures in other utility sectors have tended to support the view that ring fencing provisions perform a useful role.

2.26. The only recent financial failures in the energy sector have involved relatively small energy suppliers and those episodes were effectively handled using the 'supplier of last resort' procedures<sup>8</sup>. It is pertinent to note that all NWOs have come through the recent financial crisis without succumbing to financial distress, although some pressures remain with regard to financing requirements and there may still be aftershocks in the economic system to be faced.

2.27. Nevertheless, as set out above, we have identified a number of aspects of the ring fence that could be improved to increase their robustness and in chapter 3 we set out our proposals for addressing the issues which have been identified.

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<sup>8</sup> [http://www.ofgem.gov.uk/Licensing/Work/Revoc/Documents1/SoLR\\_revised\\_guidance\\_-\\_December\\_2008.pdf](http://www.ofgem.gov.uk/Licensing/Work/Revoc/Documents1/SoLR_revised_guidance_-_December_2008.pdf) Supply licensees are not 'protected energy companies' and so are not covered by the special administration legislation

## 3. Our preferred approach

**Chapter summary:** This chapter sets out our preferred approach for modifying the ring fence provisions with the supporting rationale.

### Question box

Question 1: Do you think we have set out enhancements to the ring fence regime that mean it would meet the identified objectives going forward?

Question 2: Do you think our preferred approach places the right emphasis on the responsibilities of NWO directors and managers?

Question 3: What are your views on the changes we have suggested to the various ring fence conditions? What additional costs might they impose on licensees?

Question 4: Do you agree that NWOs should be required to have a majority of independent directors or should the requirement refer to a minimum number? Should any licensees be exempted from such a requirement?

Question 5: Do you think that ultimate controller undertakings should be re-submitted at periodic intervals?

Question 6: Do you think that the arrangement of ring fence conditions ought to be consolidated within/across licences?

Question 7: Do you agree that changes to ring fence requirements should not be retroactive?

Question 8: Do you think that any of the proposals should be varied for different types of licensee, in particular for independent distributors?

### Our policy objective

3.1. Our aim in reviewing the licence conditions which make up the regulatory ring fence is to improve the protection they provide to consumers and to promote the financial and operational stability of NWOs. The objectives going forward therefore remain the same as those set out in chapter 1 of this document.

3.2. As set out in the previous chapter, we have identified a number of concerns with the current finance ring fence. To ensure that the ring fence is as robust as possible, we consider that some changes and enhancements to the ring fence are necessary.

3.3. We acknowledge that there needs to be a stable environment for investors and that NWOs need to be allowed to make management decisions that promote efficiency in terms of financial and operational arrangements. Improvements to the regime might provide an incremental benefit in the cost of capital for NWOs. Though this is not a main objective of the review, we are keen to ensure that changes do not unnecessarily raise the cost of capital at the expense of consumers. The regulatory ring fence should underpin the NWOs' own corporate governance regimes.

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## Proposed amendments to the ring fence

3.4. There is a spectrum of options for change, ranging from minimal to significant intrusion.

3.5. Our view is that a targeted range of enhancements to the ring fence would best achieve the objectives. Our specific proposals are summarised in box 1 and elaborated below.

3.6. However, in chapter 4 we set out possible alternative ways forward which would, respectively, involve much less and much more intrusive regulatory ring fence regimes.

### *Box 1: Proposed approach*

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| <ul style="list-style-type: none"><li>a) Strengthening of the cash lock up provision under the restriction of indebtedness by increasing the likelihood that the mechanism is triggered at a sufficiently early stage. This would be done by widening the trigger for lock up.</li><li>b) Extension of the annual availability of resources certificate submitted to the Authority to cover operational as well as financial resources. In addition, we would incorporate a requirement to produce and maintain (but not for submission to Ofgem) a formal and up to date record of key financial and contractual arrangements which could be used by an Energy Administrator either to wind up such arrangements or to maintain them as appropriate (a 'living will').</li><li>c) Clear sanctions where resource adequacy statements are found to be inaccurate or out of date.</li><li>d) Extension of the restriction on granting security under the disposal of relevant assets condition to cover current / future revenue streams and other debts held on the licensee's balance sheet (but not retrospectively).</li><li>e) We would seek to strengthen and clarify the duties of the board of a licensee suffering financial distress by introducing a requirement for there to be a majority of independent directors and make clear that we would seek penalties against managers who had provided inaccurate or insufficient information to Ofgem through bad faith or through not taking due care.</li><li>f) Other provisions remain unchanged.</li></ul> |
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3.7. We feel that our preferred approach would best promote a 'defence in depth' approach within a structured but flexible risk management system. However, these changes need to be combined with a clear regulatory stance concerning the duties and responsibilities of licensee directors and a preparedness to act with regard to a price control re-opener and/or special administration procedures should these nonetheless prove necessary.

3.8. We also need to keep our regulatory monitoring and compliance procedures under review to ensure they work effectively in the context of the existing and any enhanced ring fence conditions, making ancillary use of information gathered for economic regulation as well as targeted information requirements. During 2009 we carried out two major information gathering exercises which focussed on financial stability and organisational structures affecting NWOs. Going forward we might also require further and better reporting of relevant information specified in RIGs<sup>9</sup> documents, for example, requiring information on borrowing and lending by NWOs to support assertions that arrangements are consistent with the restriction of activity and indebtedness ring fence conditions.

3.9. NWOs have generally demonstrated a proactive and conscientious approach to compliance with ring fence requirements, not only because of legal requirements regarding the truthfulness of statements and enforcement measures which can be applied but also because of a desire to protect corporate (and to some extent personal) reputations. The scrutiny exercised by the City, investors and shareholders is of considerable value in this regard. Our position is predicated on the view that responsibility for financial stability and probity lies firmly with the directors and managers of NWO businesses. These responsibilities are underlined by legislation covering issues of personal liability and disqualification for misconduct. If an NWO had to be put into special administration, we would play an active part in reviewing the position in this context.

3.10. In making any subsequent formal modification proposals we would also seek to make the wording of conditions more consistent across the different types of licence. We do not necessarily consider it would be necessary to have dedicated sections within licences since it may be better to keep individual conditions in their current context.

3.11. A high-level summary of the proposed changes in this section is shown in Appendix 3 but, in considering it, readers are again advised to refer to the full text of the existing licence conditions.

3.12. We do not propose that any of the suggested changes should have retrospective effect. This principle would be recognised either in the drafting of modifications to conditions or through the issuing of general or specific consents under the revised conditions as appropriate. Consent mechanisms would remain an important factor in allowing restrictions to be relaxed in appropriate circumstances where the risk could be managed and where doing so would be in the interests of the NWO and consumers.

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<sup>9</sup> Regulatory Instructions and Guidance issued under licence conditions which require information returns to be submitted by NWOs

**Availability of resource requirements**

3.13. We propose that the scope of the annual availability of resources certificate is extended to cover all resources, not just financial resources. Doing so would also commensurately extend the requirement to report any subsequent adverse circumstances affecting the expectation expressed in the certificate. This would require the NWO's board to be satisfied that critical contractual relationships, (including those with related parties) are robust and that associated risks are adequately managed.

3.14. We think NWO boards could be expected to express their reasonable expectations in an extended certificate as they already have a separate requirement to approve statutory accounts, which include a going concern statement.

3.15. We also propose that the availability of resources condition should include a requirement for NWOs to produce and maintain a dedicated record of key financial, operational and contractual information of the type which could, in extremis, be readily accessed by a special administrator taking over the affairs of the company. This type of record is sometimes referred to as a 'living will'. Records containing some of this information are likely to be already maintained by NWOs in the context of disaster recovery planning. We do not propose that the record should be routinely submitted to Ofgem. The form and maintenance of the record would instead be a matter for the NWO's management, although we might provide some guidance on the type of material that such a record should include.

**Disposal of relevant assets licence condition**

3.16. We propose that the restriction on granting security/charges incorporated in this condition should be extended to cover the NWO licensee's debtors, both trade debtors and other debtors (for example in respect of loans made by the licensee). Such a change would mean that NWOs would have to exclude debtors from the terms of any new fixed or floating charges granted to banks or other creditors. The main effects of the additional restriction would be that:

- The level of 'free' assets available in the event of special administration would be likely to be higher improving the prospect that the NWO could be rescued as a going concern or successfully restructured,
- Current debtor receipts could be used as working capital by a special administrator. Although a floating charge holder could probably only lay claim to trade (book) debts extant at the commencement of insolvency, this could still represent some six to eight weeks of trading revenues,

- Debts in respect of connection works would also be available to a special administrator, although sums may be limited because such payments are usually required before works are carried out,
- The risk of administrative oversight<sup>10</sup> allowing creditors to enforce security over debtors before a special administrator is appointed would be curtailed, and
- The risk that a related party loan creditor would have to be repaid while an associated loan on the NWO's book could be claimed by a third party would be mitigated.

### **Requirement to hold an investment grade credit rating**

3.17. We are not proposing any changes to the requirements of this condition.

3.18. Notwithstanding the concerns raised in chapter 2, the holding of an investment grade credit rating provides a useful reflection of an NWO's overall financial capacity. It is a relatively objective measure based on well resourced analysis and, given that NWO's would probably need to acquire a rating even in the absence of the licence requirement, the condition involves no significant incremental cost to consumers. If, as debt issuers, NWOs did not hold investment grade ratings their debt might be considered to be of speculative grade which would make it more expensive and this cost might be passed on to consumers over time. The credit rating requirement also provides a basis for enforcement by the Authority where action by NWO management is required to address financial issues.

### **Restriction on indebtedness and transfer of funds**

3.19. Notwithstanding the concerns raised in chapter 2, the cash lock up has the potential to play an important role in conserving cash and other resources in the event of financial distress. We therefore do not propose to remove it.

3.20. However, we think there should be some improvements to the way that the cash lock up can be triggered. In particular, we are proposing to introduce two additional triggers alongside the existing credit rating trigger:

- Any report by the licensee of adverse circumstances under the availability of resources condition. The intention of this is to provide a more forward looking trigger condition, and

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<sup>10</sup> Section 164 Energy Act 2004 requires secured creditors to give 14 days notice to the Secretary of State and to the Authority before enforcing security in respect of protected energy companies

- Any breach of a formal financial covenant entered into by the licensee or any renegotiation of such a covenant for the purposes of avoiding a breach. These events would be reportable to Ofgem.

### **Restriction on activity and financial ring fencing**

3.21. We are not proposing any changes to this condition.

### **Ultimate controller undertaking**

3.22. We are not proposing any changes to this condition at the present time. However, we would be interested in respondents' views on whether there should be a requirement for the requisite deeds to be updated and resubmitted to Ofgem at periodic intervals even where the parties remain unchanged. This would help to keep the obligation to the forefront of management attention and act as a stimulus to obtain undertakings where new or additional ultimate controllers do in fact arise.

### **Requirement for appointment of independent directors**

3.23. We are considering whether the condition requiring independence of distribution businesses (and potentially a new condition in transmission licences) should require NWOs to have a majority of independent directors. We envisage that the criteria for independence would be similar to those set out in Section A.3.1. of the Combined Code on Corporate Governance dated June 2006<sup>11</sup>. This requirement would be comparable to one already placed on the holders of water supply licences.

3.24. This measure would help guard against possible conflicts of interest in respect of the fiduciary and other duties of directors where they sit on the board of both the NWO and related parties within its ownership group. Such conflicts might be precipitated or aggravated by a climate of financial distress. We would expect any new stipulations under this condition to be subject to inclusion in any compliance statement produced under the condition and any review of processes and procedures required by the licence to be carried out by a compliance officer.

3.25. We would particularly welcome responses from stakeholders on this proposal, including any comments on the levels of qualification/experience that independent directors might be expected to have.

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<sup>11</sup> <http://www.frc.org.uk/documents/pagemanager/frc/Combined%20Code%20June%202006.pdf>

The Financial Reporting Council is presently consulting on proposed revisions to the Combined Code.

## 4. Alternative options considered

**Chapter summary:** This chapter outlines alternative options for change which could be considered, their advantages and drawbacks.

### Question box

Question 1: Do you agree that these are the other broad options for change which could be considered or do you think there are additional options?

Question 2: Do you think we have attached appropriate weight to drawbacks which might be associated with the 'back-stop' measures of price control reopening and special administration?

Question 3: Do you think we have attached the right cost/benefit arguments to the less/more intrusive options?

Question 4: Do you have any comments on the more stringent regulatory possibilities identified in this chapter?

4.1. In chapter 3, we set out our preferred approach. As part of our review we have considered three alternatives to that approach:

1. Retain the existing provisions on the basis that they appear to have been largely effective,
2. Take a **less intrusive approach** to regulation around streamlined ring fence conditions – focussing on the responsibilities of NWO managers and pointing out the sanctions which could apply if directors abrogate those responsibilities,
3. Apply a **more intrusive approach** to regulation around significantly augmented ring fence licence conditions.

4.2. In reviewing these options and their possible impacts we need to be aware of the possibility of unintended consequences, in particular if assumptions that we use prove to be flawed. We also need to balance any improved safeguards against financial distress events with possible adverse impacts of additional regulatory burden and constraints on NWO management.

### Retain the existing provisions

4.3. Retaining the existing provisions without change is a realistic option given that all NWOs and their parent groups came through the height of the recent financial crisis largely unscathed. However, the crisis has brought into sharp relief the reality that ostensibly well capitalised major businesses with operations across international borders can succumb to insolvency pressures within short timescales. Although these events have, to date, mainly affected the financial sector, they warrant a reassessment of worst case scenarios for energy group businesses which has implications for NWO regulation. Given the issues identified with the existing arrangements, we do not consider a 'do nothing' approach to be appropriate.

## A less intrusive approach

4.4. A less intrusive approach could involve removing some of the existing ring fence conditions and placing greater reliance on the resource adequacy statements and the incentives on directors of licensees to ensure that these are accurate and up to date. Such an approach would minimise the amount of internal resource dedicated to monitoring and verifying information submitted to Ofgem. Specific possibilities are shown in box 2 and elaborated upon below.

### *Box 2: Specific possibilities under less intrusive approach*

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| <ol style="list-style-type: none"><li>a) Accept the licensee's annual availability of resources certificate (together with certificates lodged before any dividend) 'at face value',</li><li>b) Be clear that there are sanctions where certificates are found to be inaccurate or out of date,</li><li>c) Remove the cash lock up provision under the restriction of indebtedness in its entirety, and</li><li>d) Remove the credit rating provision in its entirety.</li><li>e) Leave other provisions unchanged</li></ol> |
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## Resource adequacy certificates

4.5. A greater reliance on the annual certificate of financial resources would imply confidence in the constraints on NWO boards to make returns in utmost good faith, and to notify us promptly of any problems or concerns. Such an approach would place the responsibility for identifying and managing financial and operating risks squarely on the shoulders of the licensees' management and could add weight to an argument for a minimum number of independent directors on licensee boards.

4.6. To underline the importance of reliable reporting, any infraction of the requirements would have to be dealt with as a serious breach of licence which could entail a fine on the licensee or, in the event of financial failure, appropriate reporting of the directors' conduct to the Secretary of State.

## Removal of the cash lock up

4.7. The rationale for removing the cash lock up would be:

- NWOs commonly subscribe to group treasury/banking arrangements such that little cash is actually held in accounts belonging to the licensee,
- The trigger (loss of investment grade credit rating) may not operate quickly enough to prevent a dissipation of any cash held by the NWO if it is caught up in the financial distress of a corporate group,

- To the extent that the cash lock up mechanism is effective, it would tend to protect creditors of the licensee rather than consumers.

4.8. The following factors militate against removal of the cash lock up:

- Finance providers attach value to the cash lock up and its removal could increase the cost of capital for NWOs,
- In the absence of a cash lock up there might be less cash available to a special administrator who might in turn have to ask for taxpayer indemnities, at least in the short term, and
- The lock up also covers assets, rights and other benefits which might be essential to the ongoing operation of a network business.

### **Removal of the investment grade credit rating requirement**

4.9. The less intrusive approach could also involve the removal of the requirement for NWOs to maintain an investment grade issuer credit rating. This would primarily reflect the factors mentioned in paragraph 2.16 but would also reflect the degree of 'circularity' in the rationale for the requirement: rating agencies view the ring fence as a positive feature and so may rate the NWO more highly than say a parent company outside the ring fence. The higher rating granted to the NWO then constitutes an important element of compliance with the ring fence requirements by the licensee concerned. Credit ratings are also to some extent subjective, for example giving weight to the perceived strength of management. Less than half of an assessment may be derived from analysis of credit metrics.

4.10. One argument for removal of this provision is that the sanction of fines on the licensee if restrictions are breached might be of limited effect in a situation where the NWO and its parent group were already facing financial distress. However, it is also open to the Authority to make enforcement orders and, in less severe financial distress scenarios, the need for a licensee to take positive steps to regain an investment grade credit rating might form a basis for remedial management action.

### **Rationale for less interventionist approach**

4.11. A less interventionist approach would be underpinned by two 'conclusive' processes available to the Authority, both of which could be expected to act reasonably quickly to prevent an adverse impact on consumers or the energy market. The first of these is a reopening of the price control settlement to relieve financial pressure where the company(ies) concerned could demonstrate that financial distress had occurred despite them operating economically and efficiently. The second is the special administration regime, under which a sale or transfer of the licensed NWO business would be achieved.

4.12. A price control reopener would not be applied in order to bail out an inefficient business. In addition, any measures would have to be 'fair' as between different

NWO businesses not least because of rules contained within the EU Directives applicable to internal markets in energy distribution and transmission<sup>12</sup>.

4.13. It is anticipated that the restructuring or sale of an NWO in special administration should be achievable in most circumstances, subject to the interest of creditors, since the business will have retained ownership of its network assets and will have access to relatively certain regulatory cash flows going forward.

### **Factors affecting reliance on a less intrusive approach**

4.14. Although investors, creditors and shareholders might be expected to bear the brunt of financial distress, reliance on these two 'backstop' measures would not rule out all possibility of an adverse impact on consumers. In the case of a price control re-opener, even where fully justified, consumers could expect to pay somewhat higher use of system charges as part of their energy bills. In addition, any losses suffered by investors and creditors resulting from the special administration of an NWO might lead to higher costs of capital in the future which might be passed on to consumers. However, neither of these effects is likely to be very significant in the context of an isolated financial distress episode.

4.15. A less intrusive approach implies greater regulatory reliance on the certification of availability of resources by NWO managers and consequently raises the stakes attached to non-compliance with those requirements.

### **A more intrusive approach**

4.16. Under a more intrusive approach we would make the enhancements to the licence ring fence conditions as set out in Chapter 3 (our preferred approach) but we would also significantly increase the number and level of detail of regulatory submissions required from NWOs. We would also increase the amount of monitoring and analysis activity that we carry out on licensees and their ownership groups to verify statements made in adequacy of resources certificates.

4.17. Such an approach might reduce the overall chance of a financial distress event or provide earlier warning than would otherwise be the case but there would be significant regulatory costs and resource implications which could lead to increased costs for NWO companies and consumers. It might also divert regulatory attention from other important economic issues, especially if we faced challenges on the legitimacy of specific requirements or had to deal with increased levels of information requests, for example under the Freedom of Information Act 2000. A considerable amount of regulatory resource is already invested in monitoring compliance with

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<sup>12</sup> Directive 2003/54/EC concerning common rules for the internal market in electricity to be repealed and replaced by Directive 2009/72/EC and Directive 2003/55/EC concerning common rules for the internal market in natural gas to be repealed and replaced by Directive 2009/73/EC

existing requirements and we have to be ready to react quickly to, for example, legal notices served on us which might necessitate urgent action under the special administration procedures. In addition, however comprehensive the regulatory scrutiny, we could not expect to consider every financial risk within a company or be likely to detect mismanagement or fraud.

4.18. Another possible problem with a more intrusive regulatory posture is that NWO managers might consider themselves absolved from some of their responsibility to manage risk, deeming some decisions implicitly approved if we had not raised objections.

### **More stringent regulatory controls**

4.19. In considering a more intrusive approach we have identified a number of more stringent suppositional possibilities for augmenting the ring fence. Although we are not suggesting these measures as part of the more intrusive approach option, we are exposing them in this document for comment. Some or all these items might be considered as 'second tier' measures if warranted by future circumstances.

#### **Tightening of the cash lock up**

4.20. It might be possible to tighten the cash lock up by prohibiting any loan facilities with related parties that are repayable on demand and/or barring all payments to related parties once the lock up is triggered, viewing any such payments as forms of distribution. However, imposing restrictions on payments properly due after a cash lock up is triggered might actually exacerbate a distress situation, especially where the NWO has operational trading relationships with the related parties concerned.

4.21. Alternatively the restriction on repayments to related parties could be extended to cover loan arrangements entered into with related parties during, say the six months preceding the trigger event. This type of precept could be consistent with references to preferential payments set out in insolvency legislation.

4.22. It might also be feasible to restrict the holding of cash attributable to the licensee in a treasury function controlled by another company and require that all regulated revenue streams be paid into an account of the licensee (and not to a related party as its agent). This could possibly incorporate restrictions on overnight sweeping of cash outside the European Community unless such funds were held in formal trust for the licensee. However, this would probably negate the financing efficiencies of such arrangements, which would again tend to increase the NWO's costs.

4.23. Another possibility might be for Ofgem to have the right to impose the cash lock up at its discretion if circumstances warranted this. For example, if one NWO in a group lost its credit rating consideration could be given to applying the cash lock up to any related NWOs on a 'cross default' basis. The concern here would be the subjectivity associated with such action which could lead to unintended consequences and which would be open to challenge by affected parties. Similarly

linking the trigger to a bespoke credit rating or defined financial ratios would involve subjectivity and involve considerable monitoring resources.

### **Availability of resources licence condition**

4.24. The availability of resources condition (or associated rules) could set particular criteria, for example relating to the percentage of debt facilities due to expire within a given time period.

4.25. We could indicate that we would be prepared to involve ourselves in discussions between NWOs and finance providers under certain circumstances or to discuss NWO-specific issues with credit rating agencies. However, it is unlikely that we would consider this to be consistent with our role as industry regulator.

### **Financial resource indemnity**

4.26. We could propose a requirement for NWOs to hold specified sums in reserve facilities to provide funding for the network business if other sources of funding, especially day to day or longer term funding from related parties, became unavailable. This could take the form of a cash-in-escrow requirement (similar to that already referred to in the credit rating alternative procedures applicable to independent distributors), the holding of guarantees from highly rated parent companies or even an industry wide 'rescue fund' based on levies.

4.27. However, for larger businesses, such arrangements would be an expensive way of addressing a relatively small (low likelihood) risk, in which case the costs to licensees and/or consumers could be disproportionate.

### **Restrictions on disposal of additional categories of assets**

4.28. The restriction on disposals of relevant assets could be extended so that consent would also be required for the disposal of/granting of security over other assets owned by NWOs such as office buildings, IT systems and vehicle fleets. Such restrictions would impose serious constraints on organisational management and would not apply to NWOs where such assets are legitimately owned and managed outside of the licensed entity or provided by third party contractors. On that basis such proposals might be challenged on grounds of unfairness.

### **Restriction of activity**

4.29. We could put forward proposals to prohibit specific risky activities by NWOs such as speculative derivatives trading, but the existing principle-based limitation to activities of the distribution business gives less scope to find 'exceptions to the rule' and the de minimis limit and consent mechanism allow such activities to take place to a limited extent where legitimately required. Conceivably we could scrutinise any director bonus schemes to see whether undue risks were being encouraged. However, monitoring such factors would almost certainly have an unreasonable

regulatory impact and the resources required would dilute programmes to check on compliance with existing restrictions.

### **Ultimate controllers and boards**

4.30. The undertaking required from ultimate controllers could be made positive – i.e. be changed to an undertaking to *take* any actions necessary to ensure that the licensee would not breach any of its licence obligations. However, this would be unlikely to be acceptable to the parties involved and would be very difficult to enforce. As with other possible changes it could not be applied retrospectively, which would again give rise to issues of fairness.

4.31. A provision might be considered that would require certain conditions to be met before a change of ownership of an NWO or which imposed restrictions in the event of a change of ultimate controller. However, such restrictions could only relate to the licensee's ability to comply with the terms of its licence, including the ring fence conditions.

4.32. Requirements could be proposed with regard to the qualifications and experience of NWO boards, which could support their independence of action or even cover the kind of 'suitability' interview carried out by the FSA with regard to key positions.

### **General points**

4.33. We could consider varying the ring fencing arrangements from one NWO to another based on risk factors. This is already done to a certain extent with respect to consents and derogations where these are justified.

4.34. It is acknowledged that measures such as those referred to above would be very intrusive and, even if conditions could be 'switched off' for some or most of the time, they would undoubtedly impinge on NWO management freedom and might therefore impact on efficiency. Consequently they might be less likely to enjoy support from licensees in respect of the acceptance of any formal licence modification proposals.

## 5. Impacts, cost and benefits

**Chapter summary:** This chapter considers the possible impact of our proposals under a number of key headings

### Question box

Question 1: Do you agree that the measures suggested in Chapter 3 (Our preferred approach) are proportionate in relation to perceived risks?

Question 2: Do you agree that our proposals would be positive for competition in the provision of energy networks and for energy supply markets?

### Requirement for the Authority to consider the impact of its proposals

5.1. Our outline proposals in Chapter 3 are intended as a pro-active and measured regulatory update package to address risks identified during the recent economic downturn. However, as we have indicated, there are alternative approaches which could be taken, each of which might have different associated costs and benefits. We are keen to obtain feedback from stakeholders on the proposals in this paper together with any views on the way that issues affecting NWO financial stability/capacity ought to be managed.

5.2. In considering and consulting on the impact of proposals the Authority is obliged to have regard to a number of key issues (outlined below) in the context of relevant legislation and official guidelines which include:

- The Gas Act 1986
- The Electricity Act 1989
- The Utilities Act 2000
- The Energy Act 2004
- Directive 2003/54/EC concerning common rules for the internal market in electricity to be repealed and replaced by Directive 2009/72/EC
- Directive 2003/55/EC concerning common rules for the internal market in natural gas to be repealed and replaced by Directive 2009/73/EC
- Social and Environmental Guidance to the Gas and Electricity Markets Authority issued by the Secretary of State (including published draft guidance)

### Impact on consumers

5.3. We do not consider that our preferred approach would have any direct impact on consumers. However, over the long term we believe that improvements to the regulatory ring fence would indirectly benefit them by enabling NWOs to continue to

raise necessary finance at low cost and reducing the likelihood and cost to consumers of financial distress.

### **Proportionality of proposals**

5.4. We are cognisant of the fact that organisational structures, business models, and financial/operational resources can vary between different types of licensee especially with regard to the substantial size differences between incumbent NWOs and relatively new independent network operators.

5.5. Although we consider that the proposals set out in chapter 3 would constitute appropriate modifications to all of the licence types, we are keen to hear from respondents who may consider that certain types of NWO would be unduly impacted by particular provisions.

5.6. Our view is that our preferred measures are proportionate in relation to perceived risks. Although the existing ring fence conditions continue to be largely fit for purpose it would be remiss of Ofgem as the regulator to adopt a 'no changes' position in light of the concerns identified.

### **Competition and markets / security and reliability of energy supplies and investment in energy networks**

5.7. Although energy networks, once established, are natural monopolies, the emergence of independent operators means that developers now have a degree of choice with regard to the provision of local infrastructure. In addition, access to reliable, financially stable networks is important to the ongoing development of competition in energy retail markets. Our proposals are intended to foster confidence in the financial and operational stability of NWOs.

5.8. We consider that our proposals are positive in each of these regards but would be interested to hear any views from respondents on these aspects.

### **Consistency with the approach of other regulators**

5.9. Although regulatory regimes are bound to vary to an extent in line with the characteristics of different industries, we would expect the same principles of promoting financial and operational stability to be generally applicable. We would be interested to hear the views of other parties in this regard.

### **Sustainable development**

5.10. This covers five important areas:

- Managing the transition to a low carbon economy
- Eradicating fuel poverty and protecting vulnerable consumers
- Promoting energy savings

- Ensuring a secure and reliable gas and electricity supply
- Supporting improved environmental performance

5.11. Although we consider that improvements in the regulatory ring fence would be generally beneficial we do not believe our proposals would have any significant direct impact in these areas.

### **Health and safety**

5.12. We do not believe that our proposals will have any direct impact in this area.

### **Risks and unintended consequences**

5.13. Risks associated with our preferred approach include the possibility that:

- it may in fact be less effective than the existing package or one of the alternative options considered
- stakeholders perceive an increased possibility that an NWO could be subject to an insolvency process
- business elements might be artificially moved outside the licensee ring fence, for example, to avoid the enhanced 'lock up' provision
- business elements might be artificially brought inside the licensee ring fence if thought necessary to facilitate resourcing certification
- changes might impact disproportionately on some NWOs because of their size or legacy arrangements which they have in place
- extensions to the cash lock up trigger and prohibition on granting of charges could 'interfere' with financing arrangements

### **Other impacts, costs and benefits**

5.14. We acknowledge that our preferred approach will impose some additional costs on licensees, for example in respect of service contracts for new, independent directors. Efficient additional costs would be funded through price controls but would consequently be passed on to energy consumers. However, we consider it unlikely that these costs would be material and that they would be outweighed by the benefits of the revised ring fence. It is hard to gauge exactly what the costs of individual proposals might be to NWOs and so we are seeking responses from stakeholders on that aspect.

### **Post-implementation review**

5.15. As noted in paragraph 6.7, we expect to issue a further consultation on the form of any proposed licence modifications before issuing any statutory notices of intent to modify licences. We would also expect to conduct a post-implementation review at an appropriate time, after the introduction of any licence modifications.

**Conclusion**

5.16. Our preferred approach, set out in chapter 3, takes into account the factors referred to in this chapter. Although we have identified a number of possible risks, we have taken these into account in arriving at our preferred approach and we consider the risks are manageable and proportionate in the context of the issues being faced. We also expect that responses to this document should allow us to refine our proposals to minimise any costs and adverse effects.

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## 6. Next steps

**Chapter summary:** This chapter sets out the next steps in the review of the ring fence conditions in energy network licences

### Responding to this consultation

6.1. This document sets out the issues identified with the existing regulatory ring fence as part of our review and stress testing of our arrangements for dealing with network companies in financial distress. It also sets out for consultation the options for change, together with our preferred approach.

6.2. We welcome views on all aspects of this consultation document/impact assessment and, in particular, on the merits of our preferred option.

6.3. Responses should be received by 23 April 2010 and should be sent to:

Paul Darby – Regulatory Finance Team  
Local Grids and RPI-X@20  
Ofgem  
9 Millbank  
London, SW1P 3GE  
Email: [paul.darby@ofgem.gov.uk](mailto:paul.darby@ofgem.gov.uk)

6.4. Unless marked confidential, all responses will be published by placing them in Ofgem's library and on our website [www.ofgem.gov.uk](http://www.ofgem.gov.uk). It would be helpful if responses could be submitted both electronically and in writing. Respondents are asked to put any confidential material in the appendices to their responses.

6.5. Respondents may request that their response is kept confidential. Respondents who wish for their responses to remain confidential should clearly mark them to this effect and include the reasons for confidentiality. Confidentiality disclaimers within emails will not be taken to represent a request for confidentiality with respect to the response itself. Ofgem shall respect this request, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

6.6. We will consider responses received by this date. Following this, we expect to consult on the form of proposed licence modifications for each type of network licence before issuing any statutory notices of intent to modify licences.

6.7. Depending on the responses we receive to this consultation we expect to carry out a further consultation on specific licence modification proposals, recognising that several types of licence held by NWOs of different types and sizes would be affected.

## Appendices

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## Appendix 1 - Consultation responses and questions

1.1. Ofgem would like to hear the views of interested parties in relation to any of the issues set out in this document. In particular, we would like to hear from network operators, finance providers, energy suppliers and consumer representatives. Please give reasons for your views with reference to this impact assessment document, or other material which you would like us to consider.

1.2. We would especially welcome responses to the specific questions which we have set out at the beginning of each chapter heading and which are replicated below.

1.3. Responses should be received by 23 April 2010 and should be sent to:

**Paul Darby**

Regulatory Finance Team  
Ofgem, 9 Millbank, London, SW1P 3GE.

020 7901 7072

[paul.darby@ofgem.gov.uk](mailto:paul.darby@ofgem.gov.uk)

1.4. Unless marked confidential, all responses will be published by placing them in Ofgem's library and on its website [www.ofgem.gov.uk](http://www.ofgem.gov.uk). Respondents may request that their response is kept confidential. Ofgem shall respect this request, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

1.5. Respondents who wish to have their responses remain confidential should clearly mark the document/s to that effect and include the reasons for confidentiality. It would be helpful if responses could be submitted both electronically and in writing. Respondents are asked to put any confidential material in the appendices to their responses.

1.6. Any questions on this document should, in the first instance, be directed to:

**Paul Darby**

Regulatory Finance Team  
Ofgem, 9 Millbank, London, SW1P 3GE.

020 7901 7072

[paul.darby@ofgem.gov.uk](mailto:paul.darby@ofgem.gov.uk)

## Appendix 2 - Current licence ring fence conditions

1.1. This appendix provides greater detail on the licence conditions that comprise the current ring fence.

### **Availability of resource requirements**

1.2. This condition requires NWOs always to have in place sufficient financial and other resources to carry out their licensed activities. A certificate must be given to the Authority by 31 July each year stating whether the board of the licensee has a reasonable expectation that it will have access to sufficient financial resources for the 12 months following the date of the certificate. The licensee must report any subsequent adverse circumstances affecting the basis of that opinion.

1.3. The certificate has to be accompanied by a statement of the main factors taken into account by the board in deciding on its form. In addition, the licensee must arrange for a report from its auditors stating whether they are aware of any inconsistencies between the certificate and information obtained by them during their audit of the licensee's regulatory accounts.

1.4. The licensee must also give a certificate to the Authority confirming its compliance with key licence conditions (including the availability of resources condition) before declaring or recommending a dividend or making any other form of distribution. The certificate must also affirm that the distribution will not lead to a future material breach of the conditions referred to. If the intended distribution does not take place within six months of the date of the certificate a fresh certificate must be provided.

### **Restriction on the disposal of relevant assets**

1.5. This condition is designed to prevent inappropriate disposals of relevant assets (operational infrastructure) which make up energy networks. Licensees must give the Authority at least two months notice of an intended disposal. The Authority can either give its consent (which may be conditional) or object to the disposal<sup>13</sup>. The term 'relevant assets' is defined in each licence, but broadly covers the pipes, wires, cables and associated equipment used to transport energy. The definition also extends to the associated land rights<sup>14</sup> and operational control rooms. For the

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<sup>13</sup> There are some 'general consent' provisions within licence conditions – see the relevant licence text under associated documents 'a' to 'd'

<sup>14</sup> Wayleaves, easements (servitudes in Scotland) and rights of access for inspection and maintenance

purposes of the condition, the term 'disposal' also includes any granting of security over relevant assets or any relinquishment of operational control.

1.6. The purpose of this condition is to ensure that each licensee retains unencumbered ownership and control of its intrinsic network. However, to facilitate flexibility the condition allows the Authority to consent to disposals that are in the interests of consumers and where the risks involved can be satisfactorily managed. In some cases, licences contain general consent sections which allow disposals to take place without specific consent from the Authority where specified criteria are satisfied.

1.7. It would be unusual for the Authority to consent to a transfer or sale of relevant assets forming a core part of an energy network. However, consents might be granted, for example where assets are redundant, or where a transfer of assets at the periphery of a network would facilitate development of a customer's premises. This stance is an important factor in our overall approach to dealing with financial distress – at any stage before, and after a requirement for a special administration order, an NWO would have ownership rights over its network which should allow cash flows to be generated and, if necessary, new finance to be raised for restructuring purposes.

1.8. It follows from the information set out above that licensees are able to dispose of any assets which do not come within the definition of relevant assets. This means that the following situations can and do subsist:

- contractual arrangements under which the day to day management and control of an NWO's network is carried out by a related party of the licensee, usually referred to as a 'resource provider',
- fixed/floating charge security held by finance providers over all of an NWO's assets, except those for which consent would be required, i.e. the relevant assets, which are 'carved out' of the scope of the charge. The security might therefore cover assets such as office premises, vehicle fleets and financial/trade debtors.

### **Requirement to hold and investment grade credit rating**

1.9. This condition requires NWOs to take all appropriate steps within their power to maintain an investment grade credit rating as defined in the licences (basically long term/senior debt ratings issued in respect of the NWO by Fitch, Moody's or Standard & Poors). The requirement exists even where the licensee is privately owned, which means there is a level of exposure to external scrutiny in all cases. The wording of the condition imposes an 'upward only' revision where a relevant rating agency alters the designation of its lowest investment grade rating, i.e. the lowest acceptable

grades would remain those presently specified, even if in future the rating agencies described a lower rating as being of 'investment grade'<sup>15</sup>. The Authority has the option of recognising additional types of rating although this would be unusual.

1.10. The Authority can specify alternative arrangements for independent distributors for whom the acquisition of an issuer grade rating would be impracticable. The alternative arrangements currently in use require the licensee to have a 'keepwell arrangement'<sup>16</sup> with a parent company and, where that parent does not itself have an investment grade credit rating, to have funds in an escrow account or equivalent facility to provide a buffer against a deficiency position.

### **Restriction of indebtedness and transfer of funds**

1.11. This condition stipulates that NWOs must not take on indebtedness except on normal (arms length) commercial terms and for the purposes of the network business. It also specifies the types of payment that can legitimately be made to related parties of the NWO and imposes a 'cash lock up' which conserves cash and other sources of value if the licensee loses, or is at risk of losing, its investment grade credit rating.

1.12. Ofgem's previous guidance on the test of 'arms length', in so far as a transaction with a related party is concerned, has been that it should be such that it would be equally practicable and appropriate for the licensee to enter into a similar transaction, on similar terms, with an unrelated counterparty of comparable standing to that of the related party. This test could apply to a licensee's decision on whether to accept an investment by way of share capital versus loan financing on particular terms. In this context the ability of NWO directors to apply independent decision making and the keeping of appropriate records on such decision making is of considerable importance.

1.13. Although the Authority can consent to a relaxation of the indebtedness restrictions, there would have to be good reasons for the granting of such consent and, in particular, a demonstration that the transaction concerned would enhance the licensee's liquidity position. A prohibition of cross default arrangements affecting the licensee is intended to prevent the importation of risk and it is highly unlikely that the Authority would consent to such an arrangement.

1.14. The cash lock up restrictions are intended to prevent any 'plundering' of an NWO's cash flow by a related party facing financial difficulties. In general, the lock up prohibits payments and transfers to related parties except for a specified range of transactions under which the NWO receives full consideration at the same time. It

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<sup>15</sup> See condition 40 in associated document 'b' for information on investment grades of credit rating

<sup>16</sup> A formal agreement to provide any resources required.

should be noted that, although it is colloquially referred to as the "cash lock up", the restriction also covers other assets, rights and benefits.

1.15. Since the lock up takes effect if the credit rating is under review for possible downgrade to speculative grade, it is to some extent forward looking. It also provides some support to the directors of a licensee in those circumstances who might otherwise come under pressure to make advanced payments, transfers or distributions to related parties. Where a repayment agreement allows for the licensee to defer repayments on an elective basis it would be expected to do so under the cash lock up. It is unlikely that the Authority would consent to a relaxation of the cash lock up once triggered unless it was part of comprehensive re-financing/re-structuring proposals which would be in the interest of consumers. We are aware that finance providers attach considerable importance to the cash lock up mechanism as part of the overall ring fence provisions.

### **Restriction on activity and financial ring fencing**

1.16. This condition prevents a licensee from carrying on activities that are not part of the network business. This is intended to prevent any diversion of management, financial or other resources to extraneous activities which may also involve unacceptable levels of commercial risk. However, NWOs are allowed to conduct a limited amount of non-network business activity which is referred to in licences as 'de minimis' business. The limit approximates to 2.5% of turnover or an investment stake of 2.5% of the licensee's share capital and reserves. The Authority can give consent for activities not to count towards this limit where appropriate.

1.17. The definition of 'de minimis' business catches all activities that are not part of the licensee's own network business. This could range from providing shared facilities to an affiliate NWO (likely) to running a chain of retail outlets (unlikely). Clearly the Authority may be more likely to consent to an extension of the limit for the former rather than the latter.

### **Ultimate controller undertaking**

1.18. This condition requires NWOs to obtain an undertaking from their ultimate controller(s), in the form of an enforceable deed between the parties, under which the ultimate controller(s) will refrain from any action that would cause the licensee to be in breach of any licence obligations. The requirement is meant to shield directors/managers in the NWO from influence exerted by an ultimate controller to act in breach of its licence. Under the terms of the undertaking the ultimate controller must also act to prevent any of its other subsidiaries from doing things which would cause the licensee to breach its licence conditions.

1.19. The licensee must report any contravention of the terms of the deed to the Authority and comply with any direction from the Authority to enforce the terms of the undertaking. The licensee is not allowed to enter into any new arrangements with the ultimate controller (or its subsidiaries) at any time when there is a breach of the undertaking, although the Authority can give consent to such arrangements. The

condition is related to a separate ultimate controller undertaking requirement in licences which covers requirements for the provision of information to the Authority.

1.20. Given the broadly 'negative' nature of the undertaking required, it is unlikely that it could be invoked to require an ultimate controller to take some positive action, for example to provide additional financial capital to the licensee. It is also questionable whether the terms of the undertaking would prevent an administrator of an ultimate controller from calling in debts due from a licensee, even if to do so could cause the licensee to experience financial resourcing difficulties.

Figure A2.1: Table of licence condition references

| Condition   | GAS                   |                   | ELECTRICITY  |                    |        |
|---|-----------------------|-------------------|--------------|--------------------|--------|
|   | GDN/NTS <sup>17</sup> | IGT <sup>18</sup> | TRANSMISSION | IDNO <sup>19</sup> | DNO    |
| Availability of resources                           | SSC A37               | SLC 44            | SLC B7       | BA3                | SLC 30 |
| Disposal of assets                                  | SSC A27               | SLC 29            | SLC B3       | SLC 29             | SLC 26 |
| Restriction on activities and financial ringfencing | SSC A36               | SLC 43            | SLC B6       | BA2                | SLC 29 |
| Credit rating                                       | SSC A38               | SLC 46            | SLC B10      | BA5                | SLC 40 |

<sup>17</sup> Ring fence conditions for regional gas distribution network operators (GDNs) and the gas national transmission system operator (NTS) are standard special conditions (SSC).

<sup>18</sup> Ring fence conditions for independent gas transporters (IGTs) are amended standard licence conditions (SLC).

<sup>19</sup> Ring fence conditions for independent (electricity) distribution network operators (IDNOs) are amended standard licence conditions in section 'BA' of their licences.

|                                      |         |        |        |     |        |
|--------------------------------------|---------|--------|--------|-----|--------|
| Indebtedness                         | SSC A39 | SLC 47 | SLC B9 | BA6 | SLC 41 |
| Undertaking from Ultimate Controller | SLC 45  | SLC 45 | SLC 8  | BA4 | SLC 31 |

## Appendix 3 - Schedule of ring fence provisions showing proposed additions

### Network licences ring fence conditions showing possible changes in square bracketed red text

*The bullet points in this appendix represent a high level summary of existing ring fencing provisions and our proposed changes. Reference should be made to the full text of the different licences for exact details of requirements.*

#### **Availability of resources**

Licensee must always have sufficient financial and other resources to carry on its network business

- Certificate to Authority by 31 July annually – sufficient financial resources for the next 12 months  
[ Certificate also to cover operational resources ]
- Statement of factors taken into account
- Auditors to confirm not inconsistent with work on last regulatory accounts
- Requirement to report change in circumstances/basis for expectations as soon as it arises
- Certificate to Authority before payment of a dividend – compliant with key licence conditions (inc availability of resources) – valid for 6 months
- [ Requirement to maintain a 'living will' record of key financial and contractual arrangements ]

## Disposal of Relevant Assets

Unless Authority consents (possibly with conditions)<sup>20</sup>

- No disposal of / granting of security over / relinquishment of control over:
  - Elements of the distribution network/control centres (and land rights)
  - Several categories of exempt disposals
  - Resource provider can take operational control (conditions and undertakings apply)
  - [ Current/future revenues (book debts) and other debts held on the licensee's balance sheet ]

## Restriction of indebtedness

Unless Authority consents:

- No indebtedness or granting of security except on normal commercial terms and for the purpose of the network business
- No payments or transfers to related parties except:
  - lawful dividend
  - lawful repayment of capital
  - payments for goods and services
  - market rate loans to related parties with investment grade credit ratings
  - repayment of loans
  - payments for group tax relief
  - acquisition of shares (for the purpose of the business or financing)
- Cash lock up if licensee loses investment grade (or on warning for downgrade)
- [ Or if licensee makes any report of changed adequacy of resources status ]
- [ Or if licensee breaches any banking or other financing covenants or enters into an arrangement to alter the terms of any such arrangements to avoid a breach ]:

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<sup>20</sup> Consent by default if Authority does not respond within two months; disposal of significant part of GB gas system requires consent of Secretary of State

- No payments to related parties except:
  - payments due for goods and services where commitment entered into before lock up
  - transfers/loans where consideration received at same time
  - loan/interest payments when due provided arrangement entered into before lock-up
  - payment for group tax relief not before tax due date

No new/renewed cross default obligations

### **Credit rating of the licensee**

- Must take all appropriate steps within its power to maintain an investment grade credit rating (long term/senior debt)
- Independent distributors have 'alternative arrangements'
  - Keepwell with parent
  - 6 months cash in escrow/on-demand bond

### **Restriction of activity and financial ring fencing**

Must not carry on activity other than network business

- Can have up to 2.5% de 'minimis' activity (or more with consent)
- Can only hold shares for the purpose of the network business or financing

### **Ultimate controller undertaking**

- Legally enforceable deed from ultimate controller(s) – copied to Authority
  - refrain from action likely to cause breach by licensee
  - impose same requirement on its other subsidiaries
- Comply with direction by Authority to enforce terms
- Report any breach of undertaking to Authority

### **Independence of the Distribution Business**

- Operational/managerial independence from supply businesses....
- [ Majority of independent directors of licensee ]

## Appendix 4 – Information relating to special administration for protected energy companies

### Issues pertinent to special administration procedures

1.1. The statutory objective of special administration is to maintain and develop an efficient and economical (network) system and either the Secretary of State<sup>21</sup> or the Authority would make the application for an order. However, third party creditors might seek to restructure debt or issue debt waivers potentially thwarting an application. The energy administration process is subject to detailed legal rules under the supervision of the court. This means that the process may not be straightforward, or 'play out' exactly as we would wish from a regulatory standpoint.

1.2. The special administration regime does form an important part of the layered defence against harm to consumers from financial distress in an NWO. Our impression is that finance providers accept the necessity for it, and its value within the regulatory framework. However, they would not wish it to be considered a measure of early resort since the returns to investment creditors might be lower than in an 'ordinary' administration. This is because the objective of special administration is to maintain and develop an efficient and economical system meaning that a liquidation of core business assets is effectively ruled out.

1.3. A deficiency arising from special administration would be unlikely to affect consumers directly because they are not generally creditors of NWOs and only have a secondary relationship with them via the contracts they have with energy suppliers. However, consumers would be likely to bear the costs of the failure over time in two respects: firstly, it is likely that the taxpayer (HM Treasury) would have to be re-reimbursed for any funds paid into the process to address a deficiency and this would be achieved by a levy on consumers and, secondly, depending on the severity of the event, the cost of capital for NWOs might rise.

1.4. It should be borne in mind that NWOs do have other classes of creditors, including smaller trade creditors who could be adversely affected by a formal insolvency process and, in some circumstances, there could be regulatory issues concerning stranded pension deficit liabilities. Shareholders would also be affected, although the normal business expectation is that they should be expected to take the 'first hit' in an insolvency. In most cases the shares in NWOs are held by other members of the same corporate group.

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<sup>21</sup> Section 156 of the Energy Act 2004 provides for the Secretary of State for Energy and Climate Change to make the application or, with his consent, the Gas and Electricity Market Authority (Ofgem)

1.5. The legislation which creates and governs the special administration for protected energy companies is contained in chapter 3 of part 3 of the Energy Act 2004 and incorporates certain specified parts of the standard administration regime contained in the Insolvency Act 1986. Although the objectives of special administration are clear, the complexity of the rules, arguments and precedents likely to apply in a given case mean that it would be very difficult to predict exactly how a special administration would proceed. There could also be uncertainty associated with the position of third party resource providers, especially companies related to the subject NWO which may or may not be subject to insolvency proceedings themselves.

### **Implications of debt waivers**

1.6. It is possible that specialist distressed debt investors could buy debt issued by an NWO or parent company which was experiencing financial distress. For a special administration order to be made the court must be satisfied either that the company is unable to pay its debts or that it is likely to become unable to pay its debts<sup>22</sup>. Specialist distressed debt investors might be in a position to issue a release or waiver of the debt with the effect that the insolvency test for the making of an order was not met (as the debt in question would no longer be due for payment). This might be a positive development in some circumstances, for example, allowing a restructuring or efficiency programme to be put in place. However, there is also a risk that aggressive cost cutting in subject companies at the behest of some types of investor seeking a return on a discounted debt purchase could put consumers' interests at risk. Our understanding is that, in general, the court is likely to be sympathetic to any possible restructuring of the debt to avert a formal insolvency order. Conversely, we understand that the court would be unlikely to give weight to proceedings in foreign courts (for example affecting foreign parent companies) in applying UK insolvency legislation.

### **Position of secured creditors in a special administration**

1.7. Secured creditors of a protected energy company are required to give the Secretary of State for Energy and Climate Change and the Authority 14 days notice before enforcing their security even where a default event has occurred under a contractual agreement. This provides a window of time in advance of security being enforced during which either the Secretary of State or the Authority (with the Secretary of State's consent) can apply to the court for a special administration order.

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<sup>22</sup> A third ground under section 157(2) of the Energy Act 2004 is that, on a petition by the Secretary of State under section 124A of the 1986 Act (petition for winding up on grounds of public interest), it would be just and equitable (disregarding the objective of the energy administration) to wind up the company in the public interest.

1.8. As with ordinary administration orders, the making of a special administration order invokes a temporary moratorium on the enforcement of security over the company's assets unless the court or the special administrator gives consent. The court would be likely to give consent if doing so would not prejudice the purpose of the special administration process. Administration is not intended to prejudice the security interests of secured creditors and they retain their proprietary rights in respect of the charged assets which could include monies<sup>23</sup>. They can also complain to the court that the administrator is not performing his functions as quickly or efficiently as is reasonably practicable or is acting in a manner which would harm the interests of secured creditors. A special administrator could be restricted in dealing with assets affected by security rights which could affect his/her freedom in achieving an optimum outcome.

1.9. A special administrator is required to conduct the administration in accordance with detailed proposals made at its outset. Assets covered by a fixed charge can only be disposed of by a special administrator with the permission of the Court and the secured creditor retains its rights over the proceeds of a disposal. Assets covered by a floating charge can be sold, but in that case the proceeds become subject to the charge in their place. It is possible that proceeds could be used to purchase other assets to which the charge would then attach, but it is unlikely that sale proceeds could be used to meet current expenses such as wage bills. It is even possible that unsecured creditors could raise objections to the use of monies in the NWO's bank account to continue trading if they envisaged funds being depleted through losses. The presence of a funder of last resort (HM Treasury) might be relevant to the court's consideration of such a representation.

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<sup>23</sup> Some charges may be voidable under insolvency legislation in certain circumstances

## Appendix 5 - Summary of questions

### **CHAPTER: One**

Question 1: Do you think we have identified the relevant objectives in our review of the ring fence? If not what other objectives should we be considering?

### **CHAPTER: Two**

Question 1: Have we identified the key risks associated with any limitations of the existing ring fence conditions?

### **CHAPTER: Three**

Question 1: Do you think we have set out enhancements to the ring fence regime that mean it would meet the identified objectives going forward?

Question 2: Do you think our preferred approach places the right emphasis on the responsibilities of NWO directors and managers?

Question 3: What are your views on the changes we have suggested to the various ring fence conditions? What additional costs might they impose on licensees?

Question 4: Do you agree that NWOs should be required to have a majority of independent directors or should the requirement refer to a minimum number? Should any licensees be exempted from such a requirement?

Question 5: Do you think that ultimate controller undertakings should be re-submitted at periodic intervals?

Question 6: Do you think that the arrangement of ring fence conditions ought to be consolidated within/across licences?

Question 7: Do you agree that changes to ring fence requirements should not be retroactive?

Question 8: Do you think that any of the proposals should be varied for different types of licensee, in particular for independent distributors?

**CHAPTER: Four**

Question 1: Do you agree that these are the other broad options for change which could be considered or do you think there are additional options?

Question 2: Do you think we have attached appropriate weight to drawbacks which might be associated with the 'back-stop' measures of price control reopening and special administration?

Question 3: Do you think we have attached the right cost/benefit arguments to the less/more intrusive options?

Question 4: Do you have any comments on the more stringent regulatory possibilities identified in this chapter?

**CHAPTER: Five**

Question 1: Do you agree that the measures suggested in Chapter 3 (Our preferred approach) are proportionate in relation to perceived risks?

Question 2: Do you agree that our proposals would be positive for competition in the provision of energy networks and for energy supply markets?

## Appendix 6 – Information on energy networks in Great Britain

### Background

1.1. Energy network businesses perform a key role in the economic and social wellbeing of consumers and commercial enterprise in Great Britain. They are responsible for transporting gas and electricity from production/import sites to the premises of domestic and commercial consumers and derive their income from use of system charges paid by shippers<sup>24</sup> and suppliers who, in turn, pass on these charges to consumers as part of their energy bills.

1.2. There are four energy transmission businesses<sup>25</sup>, fourteen regional electricity distributors and eight regional gas distributors<sup>26</sup>. There are also a number of independent gas and electricity distribution licensees who own and operate smaller networks at various locations throughout Great Britain.

1.3. In addition a number of offshore transmission assets are presently being developed and there are several interconnector licensees operating network assets which connect the GB energy networks to those in other countries.

1.4. Maps showing the disposition of the gas and electricity distribution networks in Great Britain are shown on the next two pages. For further information on energy networks and the companies which hold licences please see the relevant summary pages on the Ofgem website under:

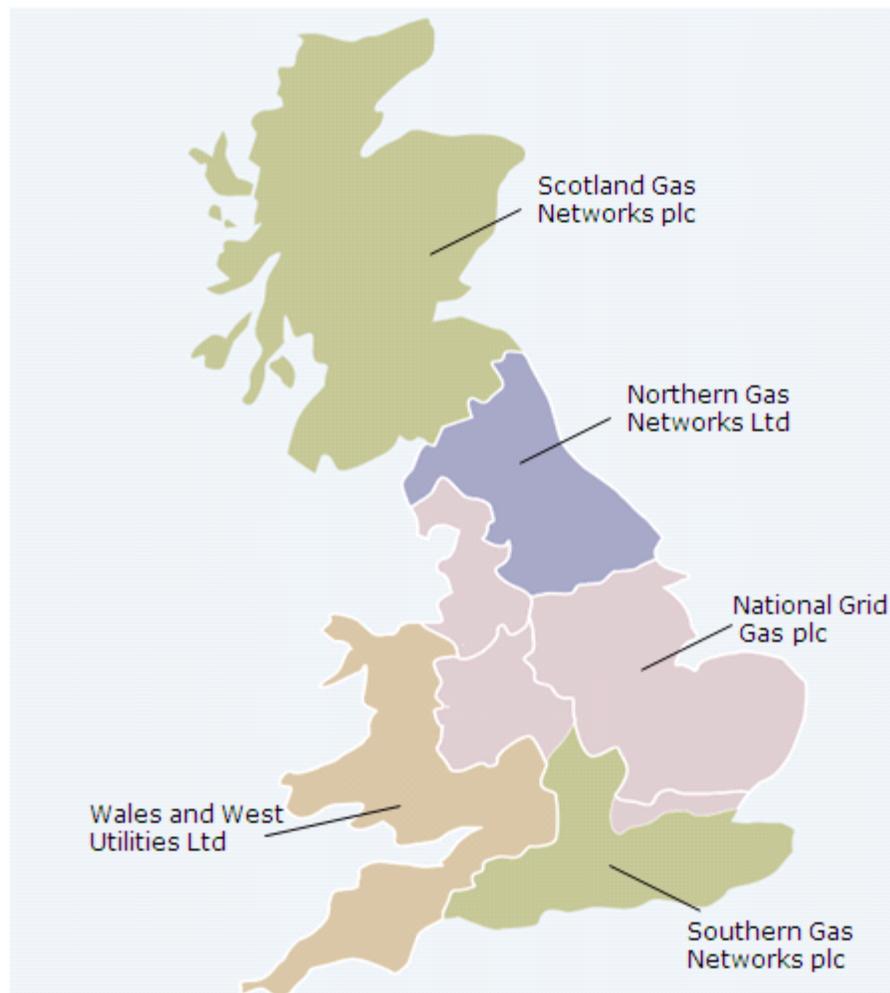
<http://www.ofgem.gov.uk/Networks/>

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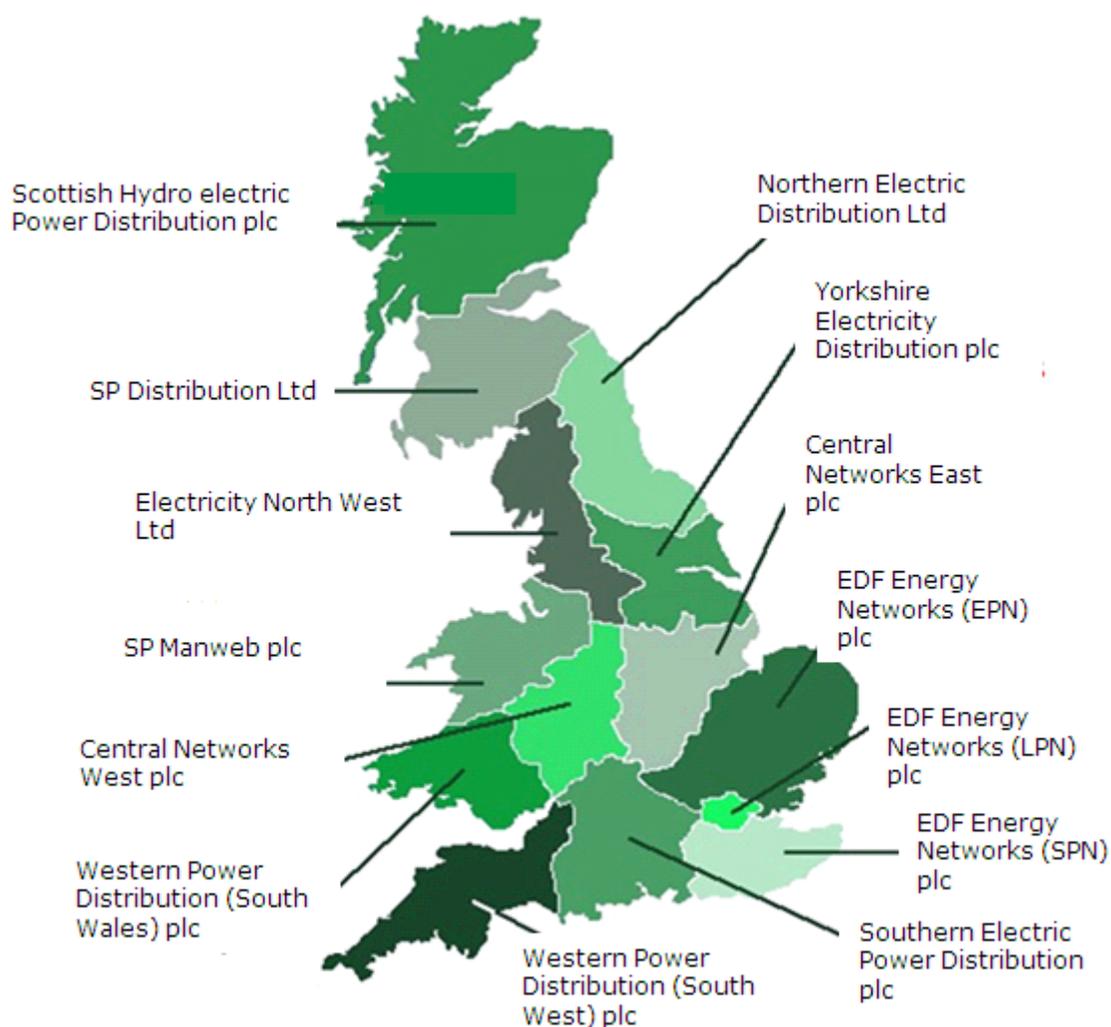
<sup>24</sup> In gas distribution, shippers arrange for the transportation of gas on behalf of suppliers. There is no equivalent for electricity distribution where suppliers deal directly with distributors.

<sup>25</sup> National Grid Electricity Transmission plc is the 'system operator' for electricity transmission throughout Great Britain, but the transmission assets in southern and northern Scotland are owned and maintained by SP transmission Ltd and Scottish Hydro Electric Transmission Ltd respectively. National Grid Gas plc own and operates the gas transmission system throughout Great Britain.

<sup>26</sup> Four of the gas distribution networks are operated under a single licence by National Grid Gas plc.

**Figure A6.1 - Map showing regional gas distribution network licensees**

**Figure A6.2 - Map showing regional electricity distribution network licensees**



## Appendix 7 – 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.<sup>27</sup>

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 accordingly<sup>28</sup>.

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 existing and future consumers, 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 them<sup>29</sup>
- the need to contribute to the achievement of sustainable development; and
- the interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas<sup>30</sup>.

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<sup>27</sup> entitled "Gas Supply" and "Electricity Supply" respectively.

<sup>28</sup> 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.

<sup>29</sup> 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.

<sup>30</sup> The Authority may have regard to other descriptions of consumers.

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:

- promote efficiency and economy on the part of those licensed<sup>31</sup> 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; 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 Regulation<sup>32</sup> 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.

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<sup>31</sup> or persons authorised by exemptions to carry on any activity.

<sup>32</sup> Council Regulation (EC) 1/2003

## Appendix 8 - Glossary

### D

#### DECC

Department of Energy and Climate Change.

### I

#### IDNO - Independent (electricity) Distribution Network Operator

An electricity distributor whose licence was granted after 1 October 2001 and whose licence does not contain obligations relating to a geographical distribution services area

#### IGT - Independent Gas Transporter

A gas transporter whose licence was granted after the 1995 amendment of the Gas Act 1986 and whose licence does not contain obligations relating to a geographical distribution services area

### N

#### NWO - Network Operator

A person holding an electricity transmission, electricity distribution or gas transporters licence. All the holders of such licences in Great Britain are corporate persons i.e. companies registered at Companies House.

### P

#### Protected Energy Company

Protected energy company" means a company which is the holder of a relevant licence; and

"relevant licence" means—

(a) a licence granted under section 6(1)(b) or (c) of the Electricity Act 1989 (transmission and distribution licences for electricity); or

(b) a licence granted under section 7 of the Gas Act 1986 (licencing of gas transporters).

**R****Related Party**

Used in this document as generic term and covering:

- Affiliate – a holding company of the licensee, a subsidiary of the licensee and any subsidiary of a holding company of the licensee
- Related undertakings – a company in which the licensee hold a participating interest – generally a shareholding over 20%

**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.

**S****Special Administration**

A formal insolvency procedure based on the normal administration process but with the specific objective of ensuring that an energy network continues to be maintained and developed as an efficient and economical system either by the rescue of the NWO company as a going concern or by the transfer of the distribution business as a going concern to one or more different companies.

**T****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.

## Appendix 9 - Feedback questionnaire

1.1. Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

1. Do you have any comments about the overall process, which was adopted for this consultation?
2. Do you have any comments about the overall tone and content of the report?
3. Was the report easy to read and understand, could it have been better written?
4. To what extent did the report's conclusions provide a balanced view?
5. To what extent did the report make reasoned recommendations for improvement?
6. Please add any further comments?

6.8. Please send your comments to:

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