MODIFICATIONS TO PUBLIC ELECTRICITY SUPPLY LICENCES FOLLOWING TAKEOVER

RESPONSE TO CONSULTATION BY THE OFFICE OF ELECTRICITY REGULATION

INTRODUCTION

On 24 February 1998, OFFER published a consultation paper on possible further modifications to be made to the Public Electricity Supply Licences of licensees that have been taken over. This followed publication of the report of the Monopolies and Mergers Commission on the PacifiCorp/The Energy Group merger reference. The proposed modifications would further strengthen the 'ring-fence' established by modifications already made to the PES licences of such licensees.

Since the publication of that paper, there have been a number of significant developments affecting electricity licensees. These have included further changes in the ownership of East Midlands Electricity and of London Electricity, both of which are now controlled by companies having important shares of the generation market in the UK; the merger of Scottish Hydro-Electric and Southern Electric, both previously independent; the announcement by Midlands Electricity of its intention to separate and divest its supply businesses; and the announcement by both ScottishPower and The National Grid Group of major overseas acquisitions. All of these cases have given rise, inter alia, to concerns similar to those the ring-fence conditions are designed to safeguard.

This paper sets out OFFER's response to the earlier consultation in the light both of comments received and the subsequent developments mentioned above. It concludes that the proposed modifications, amended where appropriate in the light of the consultation, should now be implemented in the cases of all PESs that have been taken over. Revised draft wording for each of the proposed modifications is annexed. It is presently intended that these modifications will also be incorporated when ring-fencing modifications are in due course made to the licences of ScottishPower, Scottish Hydro-Electric and The National Grid Company as OFFER has proposed.

The Consultation Paper discussed the following possible further modifications:

- where a taken over PES wishes to hold its Generation Business through an affiliate that is not a subsidiary, notwithstanding the requirement of Condition 6.1 of the PES licence, modifications to require the Generation Business to be so held and to remove purposes of the Generation Business from the definition of Permitted Purpose in Condition 1;

- modification of the de minimis exception in Condition 2A.4(e) to the general restriction on activities contained in Condition 2A.1, so as to introduce an additional test based on cumulative investment;

- modifications to incorporate in the PES licences of all taken over licensees a requirement to seek and maintain an investment grade credit rating for the licensee's corporate debt. At present, only the licences of London Electricity, Northern Electric and Yorkshire Electricity contain this condition (Condition 2D). Separately, it was for consideration whether to modify this requirement so as to operate on the basis of **issuer** rather than **issue** ratings.

- a prohibition (subject to limited exceptions of a transitional nature) on "cross default" provisions in any borrowing agreement to which a taken over PES is or becomes a party;

- a requirement that, before declaring or recommending a dividend or other distribution, the directors of a PES certify to the DGES that the licensee is in full compliance with the ring-fencing conditions of its licence and that payment of such dividend or other distribution may not be expected to result in any breach of licence conditions, either alone or when taken together with any other reasonably foreseeable circumstance, in the future;

- modifications to clarify that the undertakings required by Conditions 2B.6 and 28 to be obtained by a PES licensee from its holding company are to be given by the ultimate holding company of the group and every other person who is party to an agreement affecting the exercise of voting rights in or the appointment or removal of directors of the licensee or any company of which the licensee is a subsidiary, including (where relevant) the ultimate holding company;

- deletion of sub-paragraph (d) of the definition of Permitted Purpose in Condition 1 in order to rectify its circularity having regard to the effect of Conditions 27.5(b)(ix) and 27.5(c);

- modification of Conditions 27.5 (b) and (c) to qualify certain of those transactions not already so qualified by reference to the requirement that they be on an arm's length basis and on normal commercial terms.

VIEWS OF RESPONDENTS

Comments were received from all twelve Regional Electricity Companies in England and Wales, from Scottish Power, from Moody's Investors Service and Standard & Poor's, from the Midlands, Yorkshire and North West regional Electricity Consumers' Committees and from the Electricity Consumers' Committees Chairmen's Group.

Respondents were generally supportive of these proposals although a number had reservations about certain aspects. A significant number of respondents expressed the view that the concerns which the further modifications are designed to address apply equally to licensees in independent ownership and not only to taken over companies: fairness and consistency would require that the licences of all fourteen PESs be similarly modified. In the view of some, it might therefore be better to await the outcome of the Government's Green Paper on Utility Regulation and OFFER's consultation on the separation of

activities before implementing the proposed modifications, for which there was in any event no urgency.

Many RECs also voiced unease at the potentially retrospective effect of the amendments, in that licence modifications introduced by agreement at take-over had formed the basis on which a number of long term agreements were subsequently entered into. Such agreements might give rise to breaches of the further modifications now proposed (in particular, the prohibition on cross-default provisions) and thus require re-negotiation. This might involve significant cost and was not conducive to stability. A further point raised by most RECs concerned the date from which the further modifications are to apply: in the case of PESs that have already been taken over, they should apply from the date of modification and not that of take-over.

Most RECs considered the proposed requirement regarding dividends posed practical difficulties and urged OFFER to consider limiting the forward period to which the certificates would relate. Nearly all RECs raised in addition points of detail on a number of the proposed further modifications.

The ECCs and the ECCCG were without exception supportive of the proposals, as a further if modest step toward greater separation of monopoly and competitive businesses, but had few detailed comments.

DISCUSSION

General

Since the publication of the Consultation Paper, the Government has published its Green Paper on the future of utility regulation ("A Fair Deal for Consumers", March 1998) and has subsequently published its response to that consultation ("The Future of Gas and Electricity Regulation", October 1998). The latter document contains specific proposals for aligning and integrating the regulatory regimes for gas and electricity, for separating the supply and distribution of electricity (and, in the case of Scottish PESs, separating transmission), for introducing competition in metering and for a number of other reforms including in respect of electricity trading arrangements.

It is likely to be some time before legislation necessary to give effect to these reforms can be enacted. In the meantime, OFFER considers that it would be appropriate to implement its proposals to further strengthen the 'ring-fence' in the cases of PESs that have **already** been taken over. In connection with the merger of Scottish Hydro-Electric and Southern Electric, the respective PES licences both parties are to be modified to introduce all of the ring-fence conditions. In the case of Scottish Hydro-Electric, this will be done following a restructuring of the company to separate its PES and transmission businesses from its generation business and other activities, which the company has agreed to carry out within three years. OFFER is presently consulting on a similar restructuring of ScottishPower and ring-fencing of its Scottish PES and transmission businesses, and on a comparable ring-fencing of National Grid's transmission business. If these proposals are implemented, all PES and transmission licences will contain standardised ring-fence conditions.

Generation Business

While no objections to these proposed modifications were raised, a number of RECs sought confirmation that they would not be proposed except in the case where a PES so elects. The Consultation Paper suggested that, in the future, in the context of better separation of PES activities, it may be appropriate for all PESs to place their Generation Businesses at arm's length from their Distribution and Supply Businesses.

It is OFFER's present view that such separation would be appropriate. In developing proposals, consideration would need to be given to the implications for the own-generation limit. At present, PESs are in general restricted in the extent to which they and their affiliates may own, or hold accountable interests in, generating plant, but there is otherwise no restriction on their freedom to enter into contracts between their Supply Business and their Generation Business.

Where a PES has been taken over by another company having interests in generating plant (as in the case of East Midlands, London, Manweb and Southern) or has itself acquired further interests in generation plant (as in the case of Eastern), such that the PES's own-generation limit would be breached, the DGES has exercised (or announced proposals to exercise) his discretion to cure the breach on condition that no new contracts are entered into between the PES's Supply Business and its Generation Business (including, where relevant, plant in which its affiliates are interested). The purpose of this condition is to limit the scope for anti-competitive behaviour that might otherwise be facilitated by the vertical integration of generation and supply, and to preserve liquidity in the contracts market.

In certain of these cases, the PES has agreed to accept a licence modification (in the terms now proposed) to place its Generation Business outside the ring-fence. At present, this category includes Eastern Electricity, East Midlands Electricity, London Electricity and Southern Electric. Manweb has since its acquisition by ScottishPower been affiliated with a company having significant interests in generation such that regulatory action was required to cure a breach of its own-generation limit. OFFER therefore proposes that Manweb's PES licence should also now be so modified.

OFFER does not presently propose the modification in the case of any PES that continues to comply with its own-generation limits, in respect of whom no modification of the own-generation limit has been made or proposed nor a direction made by the DGES under Condition 6.5. Such licensees should, however, bear in mind that the matter remains under review and set their planning assumptions accordingly.

PESs to whose PES licences these modifications are not made will continue to be required by Condition 6.1 to hold their Generation Businesses through a wholly owned subsidiary and any transfer to an affiliate that is not a wholly owned subsidiary would give rise to a breach. In such cases, purposes of the Generation Business would, however, remain a Permitted Purpose and the PES would therefore continue to be free to provide financial support to its Generation Business.

PESs whose PES licences are so modified will be required to transfer the whole, but not part only, of their Generation Businesses to one or more affiliates that are not subsidiaries. In such cases, the PES would no longer be able to hold or subscribe shares in nor (otherwise than in accordance with Condition 27.5) make loans to nor create any security, give any guarantee or undertake any indebtedness for its Generation Business.

De minimis exemption

In general, there was support in principle for modifications proposed to further restrict the exemption from the general restriction on activities that may be undertaken by a PES contained in Condition 2A.1. A number of RECs pointed out that the proposed additional test, which would limit aggregate cumulative investment in ancillary activities to five per cent of the sum of share capital and reserves (on an historical cost basis), would produce differing effective limits, in relation to the scale of the licensee's overall activities, according to the level of financial gearing employed in the company.

It is not clear that this effect would be detrimental. The more highly geared is a licensee, the more vulnerable will its Distribution and Supply Businesses be to financial pressures arising from its other activities. To mitigate this risk, it would be appropriate to constrain the scale of its other activities. Moreover, the alternative of basing the test on total capital employed would necessarily entail a substantially lower percentage (say, 1 or 2%). By comparison with the formulation proposed, this might penalise the more conservatively financed licensee.

A further argument was made by some respondents, regarding the consequences of a reduction in the level of share capital and reserves. The purpose of the de minimis exemption is to deal with activities outside the scope of the permissions in Condition 2A.1 that are, in financial terms, individually insignificant. A limit as high as five per cent (whether of shareholders' funds or of turnover) may be regarded as generous for this purpose and should provide a substantial margin to accommodate fluctuations of this kind. In deciding what organisational structure is most appropriate for particular activities, management is able to take account of the constraints imposed by the licence conditions and the consequences of possible future developments. Having regard to the DGES's discretion in determining what enforcement action is appropriate in any particular case, OFFER sees no need to specify particular relief for any given circumstance.

Credit ratings

No objections were raised to the proposal that a requirement to seek and maintain investment grade credit ratings for a licensee's corporate debt, currently a condition of the PES licences of London Electricity, Northern Electric and Yorkshire Electricity, should be included in the PES licences of all taken over PESs.

In relation to the question whether it would be practicable to base the condition on **issuer** ratings rather than **issue** ratings (the formulation on which the existing Condition 2D of the relevant licences is based), conflicting views were expressed both by RECs and by the credit rating agencies.

OFFER continues to hold the view that **issuer** ratings would provide a more satisfactory basis for the proposed Condition, obviating the definitional difficulties described in the earlier Consultation Paper, and capturing those licensees that (now or in the future) have no outstanding borrowings of the type requiring to be rated under the existing condition. Nevertheless, the adoption of a requirement based on **issuer** ratings might require some changes in the practices and policies of all, or at least some, of the credit rating agencies. It is not clear that it is appropriate for DGES to act in such a way. For the present, therefore, OFFER proposes to retain the existing formulation but would welcome moves by PESs to obtain and publish **issuer** ratings from reputable credit rating agencies.

A number of respondents were concerned at the latitude over choice of rating agency afforded to the licensee by the wording of the proposed condition. It was felt that this might lead licensees to seek indicative ratings from a number of agencies but not formalise any that fell below the required level. This might lead to a lack of comparability between apparently equivalent ratings. OFFER considers that it would be inappropriate to fetter normal commercial practice, nor to act in a way that might be perceived to give undue advantage to certain agencies over others. However, OFFER monitors the statistics published by the rating agencies relating to historical default rates among rated issues, and would expect to apply this criterion in assessing the equivalency of ratings assigned by different agencies. If necessary, OFFER would propose further modification of this condition to reduce scope for abuse.

Cross-default provisions

There was broad recognition among respondents that this proposal is, in principle, sensible. A number of concerns were expressed about the draft definition of 'cross-default' which was felt by some to lack precision, giving rise to uncertainty as to what would be permitted and what not. Others were concerned that the permissible exceptions were too restrictive, especially as regards subsidiaries, and that the period of time allowed for transition was too short.

In particular, it was felt that banks and other lenders would require significant risk premia for loans to PES that have subsidiaries if subsidiary default would not entitle them to accelerate repayment of their loans. Moreover, in cases where it would be necessary to refinance existing borrowings in order to avoid breach of the condition, especially borrowings under longer term arrangements, it was likely that significant costs would be incurred, including in some cases contractual penalties. Some respondents argued that allowance should be made for such costs in the price controls. Others argued that all borrowing agreements subsisting at the date on which the condition becomes effective should be exempt.

OFFER has taken external professional advice on the proposed definition of cross default and, subject to certain technical drafting amendments, considers that it remains appropriate to the purpose and consistent with present practice in bank and other credit markets. To recapitulate, the purpose of this condition is to prevent a PES being placed in a situation where its own liabilities in respect of debt finance, howsoever arising and wherever in its group the proceeds are employed, can arise, crystallise prematurely or be increased as a

result of default by another person over whom the PES does not exercise full control (so as to prevent, so far as its PES licence allows, such a default occurring). Regardless of the scale of the default, in the absence of a restriction of the kind proposed the occurrence of such an event could have the effect of triggering a collapse of the PES's own financing arrangements, because of the existence of cross-default clauses.

The proposed definition extends to a potentially wide range of financing agreements, and not simply to agreements whereunder the PES itself incurs indebtedness for money borrowed. This is intentional, in view of the equally wide definition of default typically employed in financing agreements to which PESs become parties. However, it is necessary to ensure consistency of this provision with the approach taken to other aspects of the 'ring-fence'. For example, the 'ring-fence' conditions permit a PES to provide unlimited financial support to a subsidiary for a Permitted Purpose, thus exposing its resources to the risk of the subsidiary's failure. If the PES were unable to give protection against this exposure to its own lenders, in the form of a cross-default clause, this might have the effect of preventing the PES from providing requisite support for a Permitted Purpose.

OFFER has therefore amended the proposed modification so as to exempt all cross-default obligations that arise only as the result of default by a subsidiary of the licensee where, at any time when the relevant agreement is in force, (i) the licensee holds a majority of the voting rights and has power to appoint and remove a majority of the directors of the subsidiary, and (ii) the subsidiary conducts business only for a purpose within sub-paragraphs (a), (b) or (c) of the definition of Permitted Purpose. So far as other cross-default obligations are concerned, OFFER is minded to retain the twelve month transitional exemption substantially in the form of the draft appended to the earlier consultation paper.

OFFER considers that this amendment should go a long way to meeting the concerns of RECs regarding the potential impact of the condition on the future cost of debt, while preserving the protection provided by the condition against the pressures arising from third party default identified by the MMC in the PacifiCorp report. It also addresses arguments to the effect that allowance should be made in price controls for any increased costs resulting from renegotiation or refinancing of existing arrangements necessitated by the new condition. Arrangements under which cross default obligations of the PES arise solely from subsidiaries carrying on activities for purposes of the PES's Distribution, Supply and Second-tier supply businesses would not require to be renegotiated or refinanced. The costs associated with any necessary rearrangement of other facilities should, therefore, be attributable to other activities.

A number of respondents argued that his modification might have retrospective effect inasmuch as long-term borrowing agreements, entered into on the basis of licence modifications introduced by agreement at take-over, may require to be renegotiated in order to avoid breach. It should be noted that, as drafted, DGES would retain discretion under this condition. In exercising his discretion, the DGES would consider carefully any arguments put to him in respect of specific cross-default arrangements subsisting at the date the modification becomes effective.

Dividends

OFFER has proposed that, before recommending or declaring any dividend or other distribution, the directors of a PES should certify to the DGES that the licensee is in compliance with the ring-fencing conditions of its PES licence and that payment of the dividend or making of the distribution would not result, either alone or when taken together with any other reasonably foreseeable circumstance, in a breach of such conditions.

The majority of PES respondents argued that the requirements of existing Condition 2B are sufficient and that the proposed new requirement is therefore unnecessary. It was also pointed out that DGES already has powers enabling him to take enforcement action if he considers a particular dividend or other distribution to have resulted in breach of a licence condition or to be likely to cause a breach in the future. (Condition 2B.1 requires each licensee at all times to act in a manner calculated to secure that it has sufficient management resources and financial resources and facilities to enable it to carry on its Supply and Distribution businesses and to comply with its obligations under the Electricity Act and its PES licence. Condition 2B.2 requires that Directors certify to DGES annually that, taking account among other things of dividends expected to be paid in the future, the licensee has sufficient financial resources and facilities to enable it to carry on its Supply and Distribution businesses for a period of twelve months from the date of the certificate.)

Concern was expressed at the additional cost and administrative burden that would result from the proposed additional requirement, especially in relation to the requirement for an accompanying auditor's certificate, and at the scope of the declaration required. In particular, it was argued that the future period to which the certificate relates should be limited and that the declaration should be qualified as to materiality. It was also argued that the range of factors to which Directors would need to have regard in giving the certificate extends beyond matters over which they can have influence. For example, a credit rating may be downgraded because of a change in macro-economic conditions. For these reasons, the new requirement was considered by a small minority to be objectionable in the form proposed, though none objected to the principle.

OFFER continues to believe there is merit in this proposal. The existing requirements of Condition 2B.1 relate only to the adequacy of financial resources and facilities in the twelve month period following the giving of a certificate in accordance with the Condition, taking account of dividends and other distributions to be made in the period. Yet the payment of a dividend or making of a distribution may have an effect on the availability of adequate financial resources and facilities at a more distant time. There is merit in ensuring Directors take a longer term view of the licensee's requirements in reaching decisions regarding the payment of dividends and other distributions, up to the limit of what is reasonably foreseeable.

Moreover, the existing provisions would not prevent payment of a dividend or making of a distribution even if the licensee were in breach of its ring-fencing obligations or would be as a result of the dividend or distribution. The scope of enforcement action available to DGES would be effectively constrained where a dividend paid in accordance with the

provisions of company law nonetheless contributed to or exacerbated a licence breach. A specific provision that, in effect, requires Directors of a licensee, before the dividend is paid, to be satisfied that such circumstances will not foreseeably arise affords protection against this constraint. It would also provide protection for Directors faced with pressure to declare excessive dividends.

For similar reasons, OFFER would not wish to restrict the future period to which the required declaration relates. It is recognised that it may only be possible to conclude after a circumstance has arisen whether it was reasonably foreseeable at some earlier time. But this does not in law exonerate a decision-taker in respect of circumstances, however distant, which should properly have been foreseen when the decision was taken; and the Courts are practised in such determinations. Nor, to be foreseeable, must a matter be within a person's scope to influence. Boards of directors routinely face the need to make judgements about matters beyond their scope to influence and, in the name of the company, take responsibility for those judgements. It does not seem unreasonable to apply similar standards in establishing the present proposal.

OFFER accepts, however, the arguments that the required declaration should be qualified by reference to materiality, that the timing of Board approval of the certificate in relation to the formal recommendation or declaration of the relevant distribution can be simplified and that a requirement for an accompanying auditor's certificate would not in this case add value commensurate with the potential cost involved.

Drafting amendments

Three further modifications of existing licence conditions were proposed in OFFER's earlier paper with a view to clarifying ambiguities in the current drafting:

- to introduce a new definition of 'holding company' so as to ensure that it is clear the obligation of the licensee to obtain certain undertakings from its holding company, in accordance with the requirements of Conditions 2B.6 and 28, relates to the licensee's ultimate holding company or other parental entity (and, if there is more than one, from all such ultimate parental entities);

- to delete sub-paragraph (d) of the definition of Permitted Purpose so as to resolve the circularity it creates, which, in the view of the MMC, renders Condition 27.5 somewhat unclear;

- to qualify the permissions contained in sub-paragraphs (vi) and (viii) of paragraph (b) and in paragraph (c) of Condition 27.5 so as to limit them to relevant transactions carried out on an arm's length basis and on normal commercial terms.

A number of drafting improvements were suggested in relation to the proposed new definition of holding company by various respondents, but no substantive comments were received.

Three REC respondents raised objections to the proposed amendment of the definition of Permitted Purpose. The principal concern expressed was that the amendment would have

the effect of requiring consent of DGES to the undertaking of indebtedness by a PES to finance transactions of the kind permitted by Condition 27.5(b), including, in particular, the payment of dividends. This would not necessarily be the case. For example, no consent would be required for borrowings undertaken to finance such a transaction if it was for a purpose of any of the Supply, Second-tier Supply, Distribution or (unless excluded by modification) Generation businesses, or of any business or activity within the limits of the *de minimis* exception or carried on before the take-over date. It is also arguable that the payment of dividends by a PES licensee is a purpose of its authorised activities, at least to the extent of any dividend required to raise necessary finance for those activities. In these circumstances, at least, the proposed amendment would not have the effect contended by these respondents.

Sub-paragraph (d) of the present definition of Permitted Purpose was intended to place such matters beyond doubt, rather than to extend the definition substantively beyond the scope of sub-paragraphs (a), (b) and (c). Having considered the responses to the earlier consultation paper, OFFER does not now propose to delete sub-paragraph (d). However, in the light of this, OFFER is reinforced in its view that it would be appropriate to amend Condition 27.5 in order to make clear that it is not intended to permit transactions with or for the benefit of affiliates of a sort which might undermine the purposes of the financial ring-fence.

In particular, it would be appropriate to delete the proviso to paragraph (a) and to qualify sub-paragraphs (vi) and (viii) of paragraph (b) of Condition 27.5 so as to permit only those relevant transactions that are on an arm's length basis and on normal commercial terms. In addition, to resolve the circularity in the definition of Permitted Purpose, it is proposed to amend sub-paragraph (iv) of paragraph (b) to include explicit reference to loans of money and to delete sub-paragraph (ix) of paragraph (b) and paragraph (c) (and to make appropriate consequential amendments to sub-paragraph (d) of the definition of Permitted Purpose).

The effect of these changes will be to preclude an affected PES, after the date on which the modification becomes effective, from entering into any transaction with an affiliate otherwise than on an arm's length basis and on normal commercial terms (save in respect of dividends and repayments of capital within the limits imposed by the Companies Acts, transfers within Condition 27.5(b)(vii) and otherwise with the consent of the DGES). OFFER attaches considerable importance to this licence condition. It implies that a PES may not enter into any transaction with an affiliate if it would not also enter into a similar transaction (including as to all material terms and conditions) with an unrelated party of comparable standing. The onus will be on the directors of the PES to satisfy themselves in this regard and, if called upon to do so, to justify the basis of any affiliate transaction to the DGES. OFFER intends to monitor evidence of affiliate transactions and may propose further measures if abuse becomes apparent.

CONCLUSION

It is intended to implement the proposed modifications as soon as practicable. The Director General will be writing to all affected licensees seeking their acceptance. Revised drafts of the relevant modifications are attached.

11 February 1999

FURTHER TIGHTENING OF RING FENCE

APPENDIX

This appendix contains the proposed modifications to the PES licence. The modification relating to the Licensee's generation business set out at number 6 below is an elective modification. All the other modifications listed will be proposed for each of the PESs in England and Wales which have been taken over.

1. Modifications to the definition of permitted purpose in Condition 1.

2(a). A new definition of ultimate holding company to be inserted in Condition 1.
(b). Modifications to the requirements for undertakings in Conditions 2B.6, 28.2 and 28.4

3. Modifications to the de minimis provisions in Condition 2A.

4. Modifications relating to dividends and other distributions to be added to Condition 2B.

5. Modifications relating to the requirement for credit rating for corporate debt of the Licensee to be added to Condition 2D.

6. Elective modification providing for the generation business of the Licensee to be held by a non-subsidiary affiliate of the Licensee (Condition 6), with associated modifications to Conditions 1 and 2A.

7. Modifications to the restrictions on charging and disposals in sub-paragraphs 5(a), 5(b) and 5(c) of Condition 27.5.

8. Modifications relating to cross-default obligations to be added to paragraphs 5 and 6 of Condition 27.

1. PROPOSED MODIFICATIONS TO DEFINITION OF "PERMITTED PURPOSE" IN CONDITION 1

The definition of Permitted Purpose will be amended to read:

""Permitted Purpose" means the purpose of all or any of the following:

(a) the Supply Business, the Second-Tier Supply Business, the Distribution Business or any business or activity within the limits of paragraph 5 of Condition 2A;

(b) the Generation Business;

(c) any business conducted or activity carried on on [day before first take-over offer unconditional] by the Licensee or by a company which was an affiliate or related undertaking of the Licensee on that date; and

(d) without prejudice to the generality of paragraphs (a) to (c), any payment or transaction lawfully made or undertaken by the Licensee for a purpose within sub-paragraphs (i) to (viii) of paragraph 5(b) of Condition 27."

Note: the elective modification to Condition 6 includes additional modifications to this definition.

2(a). PROPOSED MODIFICATION TO PES LICENCE CONDITION 1.3 DEFINITION OF ULTIMATE HOLDING COMPANY

The following new definition will be added to Condition 1.3:

Ultimate holding company means each of

(i) a holding company of the Licensee which is not itself a subsidiary of another company;

(ii) where a holding company of the Licensee which is not a subsidiary of another company has entered into an agreement affecting the exercise of voting rights in or the appointment or removal of directors of the Licensee or any company of which the Licensee is a subsidiary, every party to that agreement; and

(iii) where the exercise of voting rights in or the appointment or removal of directors of a holding company of the Licensee which is not a subsidiary of another company is controlled by an agreement, every party to that agreement.

2(b). PROPOSED MODIFICATIONS TO PES LICENCE CONDITIONS 2B.6, 28.2 AND 28.4 UNDERTAKINGS BY ULTIMATE HOLDING COMPANIES

1. Amend Condition 2B.6 to read:

> "6. The Licensee shall procure from each company or other person which is at any time an ultimate holding company of the Licensee a legally enforceable undertaking in favour of the Licensee in the form specified by the Director that that ultimate holding company ("the Covenantor") will refrain from any action, and will procure that every subsidiary of the Covenantor (other than the Licensee and its subsidiaries) will refrain from any action, which would then be likely to cause the Licensee to breach any of its obligations under the Act or this Licence. Such undertaking shall be obtained within 7 days of the company or other person in question becoming an ultimate holding company of the Licensee and shall remain in force for so long as the Licensee remains the holder of this Licence and the Covenantor remains an ultimate holding company of the Licensee."

2. Amend Condition 28.2 to read:

> "2. The Licensee shall procure from each company or other person which is at any time an ultimate holding company of the Licensee a legally enforceable undertaking in favour of the Licensee in the form specified by the Director that that ultimate holding company ("the Covenantor") will give to the Licensee, and will procure that each subsidiary of the Covenantor (other than the Licensee and its subsidiaries) will give to the Licensee, all such information as may be necessary to enable the Licensee to comply fully with the obligations imposed on it in paragraph 1. Such undertaking shall be obtained within 7 days of the company or other person in question becoming an ultimate holding company of the Licensee and shall remain in force for so long as the Licensee remains the holder of this licence and the Covenantor remains an ultimate holding company of the Licensee."

3. Amend Condition 28.4 to read:

> "4. The Licensee shall not, save with the consent in writing of the Director, enter (directly or indirectly) into any agreement or arrangement with any ultimate holding company of the Licensee or any of the subsidiaries of such ultimate holding company (other than the subsidiaries of the Licensee) at a time when:
>
> (i) an undertaking complying with paragraph 2 is not in place in relation to that ultimate holding company; or
> (ii) there is an unremedied breach of such undertaking."

3. PROPOSED MODIFICATION TO PES LICENCE CONDITION 2A DE MIMIMIS EXEMPTION

1. Delete sub-paragraph (e) of paragraph 4 (and make appropriate modification to definition of Permitted Purpose in Condition 1).

2. Substitute for it the following new paragraph 5:

5. Nothing in this Condition shall prevent the Licensee conducting ancillary business as defined in this paragraph so long as the limitations specified in this paragraph are complied with.

(a) For the purpose of this paragraph "ancillary business" means any business or activity carried on by the Licensee other than the Supply Business, the Second-Tier Supply Business and the Distribution Business .

(b) The Licensee may carry on ancillary business provided that neither of the following limitations is exceeded, namely:

(i) the aggregate turnover of all the ancillary business of the Licensee does not in any period of twelve months commencing on 1 April of any year exceed 5% of the aggregate turnover of the Supply Business, the Second-Tier Supply Business and the Distribution Business (excluding the turnover on transactions which the Supply Business the Second-Tier Supply Business and the Distribution Business make with each other) as shown by its most recent audited accounting statements produced under sub-paragraphs (b)(i) and (c) of paragraph 3 of Condition 2; and

(ii) the aggregate amount (determined in accordance with sub-paragraph (d) below) of all investments by the Licensee in all its ancillary business does not at any time after [later of take-over date and date modification has effect] exceed 5% of the sum of share capital in issue, share premium and consolidated reserves of the Licensee as shown by its most recent audited historic cost financial statements then available.

(c) For the purpose of sub-paragraph (b) of this paragraph, "investment" means any form of financial support or assistance given by or on behalf of the Licensee for the ancillary business whether on a temporary or permanent basis including (without limiting the generality of the foregoing) any commitment to provide any such support or assistance in the future.

(d) At any relevant time, the amount of an investment shall be the sum of (i) the value at which such investment was included in the audited historic cost balance sheet of the Licensee as at the latest accounting reference date to have occurred prior to [later of take-over date and date modification has effect] (or, where the investment was not so included, zero), (ii) the aggregate gross amount of all expenditure (whether of a capital or revenue nature) howsoever incurred by the Licensee in respect

of such investment in all completed accounting reference periods since such accounting reference date and (iii) all commitments and liabilities (whether actual or contingent) of the Licensee relating to such investment outstanding at the end of the most recently completed accounting reference period.

3. Amend the opening words of paragraph 1 of Condition 2A to read "Save as provided by paragraphs 3, 4 and 5, the Licensee shall not..."

4. PROPOSED MODIFICATION TO PES LICENCE CONDITION 2B RESTRICTION ON PAYMENT OF DIVIDENDS ETC

The following new paragraph 8 will be added to Condition 2B:

8. The directors of the Licensee shall not declare or recommend a dividend, nor shall the Licensee make any other form of distribution within the meaning of Section 263 of the Companies Act 1985, unless prior to the declaration, recommendation or making of the distribution (as the case may be) the Licensee shall have issued to the Director a certificate complying with the following requirements of this paragraph.

   (a) The certificate shall be in the following form:

   "After making enquiries, the directors of the Licensee are satisfied:

   (i) that the Licensee is in compliance in all material respects with all obligations imposed on it by Condition 2A, Condition 2B, Condition 2D, paragraph 5 of Condition 27 and paragraph 2 of Condition 28 of its public electricity supply licence; and

   (ii) that the making of a distribution of [ ] on [ ] will not, either alone or when taken together with other circumstances reasonably foreseeable at the date of this certificate, cause the Licensee to be in breach to a material extent of any of these obligations in the future."

   (b) The certificate shall be signed by a director of the Licensee and approved by a resolution of the board of directors of the Licensee passed not more than 14 days before the date on which the declaration, recommendation or payment will be made.

   (c) Where the certificate has been issued in respect of the declaration or recommendation of a dividend, the Licensee shall be under no obligation to issue a further certificate prior to payment of that dividend.

5. PROPOSED MODIFICATION TO PES LICENCE CONDITION 2D CREDIT RATING OF LICENSEE

Condition 2D will be amended to read as shown below, and included in all PES licences:

1. The Licensee shall use all reasonable endeavours to ensure that:

   (a) any corporate debt of the Licensee in issue at [later of day before take-over date and date modification has effect] which had an investment grade credit rating at that date maintains an investment grade credit rating throughout the period during which such debt remains outstanding, and

   (b) any corporate debt, other than corporate debt issued by way of negotiated private placement, issued by the Licensee on or after the [later of take-over date and date modification has effect] has and maintains an investment grade credit rating throughout the period during which such debt remains outstanding.

2. For the purpose of paragraph 1:

   (a) "corporate debt" means any unsecured and unsubordinated borrowing of money having an initial maturity of five years or more, and

   (b) "investment grade credit rating" means:

   - a rating of not less than BBB- by Standard & Poor's Ratings Group or any of its subsidiaries or not less than Baa3 by Moody's Investors Service, Inc. or any of its subsidiaries or such higher rating as shall be specified by either of them from time to time as the lowest investment grade credit rating, or

   - an equivalent rating from any other reputable credit rating agency which has comparable standing in the UK and the USA.

6. ELECTIVE MODIFICATION TO PES LICENCE CONDITIONS 1, 2A AND 6 GENERATION BUSINESS

Where the Generation Business is to be held outside the ring-fence:

1. In Condition 1, the definition of "Permitted Purpose" will be amended:

(a) by deleting sub-paragraph (b); and

(b) by adding the words, "other than the Generation Business" after "on [take-over date]" in sub-paragraph (c).

2. In Condition 2A, the words "other than the Generation Business" will be inserted at the end of sub-paragraph (a) of paragraph 2.

3. In Condition 6, paragraph 1 will be amended to read as follows:

"1. The Licensee shall procure that, with effect from [date modification is effective], the Generation Business of the Licensee is held as a Separate Business by an affiliate of the Licensee in which the Licensee has no shareholding interest of any kind, whether direct or indirect."

7. PROPOSED MODIFICATION TO PES LICENCE CONDITION 27.5(a), (b) and (c) AMENDED RESTRICTIONS ON CHARGING AND DISPOSALS

1. Sub-paragraphs (a) and (b) of paragraph 5 will be amended to read:

5. Without prejudice to paragraphs 1 to 4, the Licensee shall not after [date when modifications become effective] without the written consent of the Director after disclosure of all material facts:

(a) create any mortgage, charge, pledge, lien or other form of security or encumbrance whatsoever, undertake any indebtedness to any other person or guarantee any liability or obligation of another person otherwise than:

(i) on an arm's length basis;
(ii) on normal commercial terms;
(iii) for a Permitted Purpose; and
(iv) (if the transaction is within the ambit of paragraph 1) in accordance with paragraphs 3 and 4;

(b) transfer, lease, license or lend any sum or sums, asset, right or benefit to any affiliate or related undertaking of the Licensee otherwise than by way of:

(i) a dividend or other distribution out of distributable reserves;

(ii) repayment of capital;

(iii) payment properly due for any goods, services or assets provided on an arm's length basis and on normal commercial terms;

(iv) a transfer, lease, licence or loan of any sum or sums, asset, right or benefit on an arm's length basis and on normal commercial terms;

(v) repayment of or payment of interest on a loan not prohibited by sub-paragraph (a);

(vi) payments for group corporation tax relief or for the surrender of Advance Corporation Tax calculated on a basis not exceeding the value of the benefit received;

(vii) a transfer for the purpose of satisfying paragraph 3 of Condition 2A;

(viii) an acquisition of shares in conformity with paragraph 2 of Condition 2A made on an arm’s length basis and on normal commercial terms.

2. Sub-paragraph (c) of paragraph 5 will be deleted.

8. PROPOSED MODIFICATION OF PES LICENCE CONDITION 27.5 and 27.6 RESTRICTION OF CROSS-DEFAULT OBLIGATIONS

1. Add new sub-paragraphs (c), (d) and (e) to paragraph 5 of Condition27 as follows:

(c) enter into an agreement or incur a commitment incorporating a cross-default obligation, or

(d) continue or permit to remain in effect any agreement or commitment incorporating a cross-default obligation subsisting at [later of day before take-over date and date modification has effect] save that the Licensee may permit any cross-default obligation in existence at that date to remain in effect for a period not exceeding twelve months from that date, provided that the cross-default obligation is solely referable to an instrument relating to the provision of loan or other financial facilities granted prior to that date and the terms on which those facilities have been made available as subsisting on that date are not varied or otherwise made more onerous.

(e) the provisions of sub-paragraphs (c) and (d) of this paragraph shall not prevent the Licensee from giving any guarantee permitted by and compliant with the requirements of sub-paragraph (a) of this paragraph.

2. Add a definition of "cross-default obligation" to paragraph 6 as follows:

"cross-default obligation" means a term of any agreement or arrangement whereby the Licensee's liability to pay or repay any debt or other sum arises or is increased or accelerated or is capable of arising, increasing or of acceleration by reason of a default (howsoever such default may be described or defined) by any person other than the Licensee, unless:

(i) that liability can arise only as the result of a default by a subsidiary of the Licensee, and

(ii) the Licensee holds a majority of the voting rights in that subsidiary and has the right to appoint or remove a majority of its board of directors, and

(iii) that subsidiary carries on business only for a purpose within sub-paragraphs (a), (b) or (c) of the definition of Permitted Purpose.

Note: paragraph 2(iii) will require amendment if the elective modification to Condition 6 is adopted.