

Hannah Nixon
Director, Regulatory Review
The Office of Gas and Electricity Markets
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22 June 2009

Dear Hannah

Arrangements for responding in the event that an energy network company experiences deteriorating financial health: Consultation Document

CE Electric UK Funding Company (CE) has reviewed the above Consultation Document which was published on 11 May 2009 and considered the questions posed by Ofgem therein.

CE is largely satisfied with the arrangements outlined in the Consultation Document. Our responses to the various questions and some additional comments are outlined below.

BACKGROUND TO THE ENERGY ADMINISTRATION REGIME

Question 1 - What are respondents' views on the overall structure of the guidance document?

CE is largely comfortable with the structure of the guidance document although we have some minor reservations as outlined in our responses to the questions raised as outlined below.

However, we consider that the document needs to include a section on the role of the Pension Regulator in the event that pension deficit payments lead a Protected Energy Company (PEC) into financial distress. This additional section would outline how the energy administrator will deal with the issue of pension funding.

Question 2 - Do respondents consider that any other aspect of the response plan should be addressed in the guidance document?

No substantive comments.

CE ELECTRIC UK FUNDING COMPANY

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PROCESS OVERVIEW AND BACKGROUND INFORMATION

Question 1 - Do respondents agree with the stated purpose of the guidance document as set out in Chapter 1 of that document?

CE is in general agreement with the stated purpose of the guidance document other than:

1. in paragraph 1.2.2 of the Draft Guidance Document it states that the monitoring arrangements are not disclosed in detail. We believe that they should be disclosed in greater detail so that there is sufficient transparency for all stakeholders as to when the arrangements will, or at least likely to, be triggered; and
2. the financial health of major generation companies is something that should receive some consideration. We appreciate that these entities are not PECs and are therefore subject to a different regime. However, Ofgem will be aware that the failure of a major generator could have repercussions that are significant due to the significant impact of failure on the security of the supply of energy.

Question 2 - Do respondents have any comments on the background to energy administration as set out in Chapter 2 of the guidance document?

Whilst the document reflects most situations that could lead to financial distress, it remains silent on the potential impact of a series of weather related incidents and the impact of significant changes in the financial market conditions in the UK. It is possible that a PEC might become distressed through the combination of more than one factor. If a single factor is the cause of the distress, it is quite likely that the distress will be felt by more than one PEC.

The document also remains silent on the impact of borrowing covenants and liquidity on PECs. The financial distress could arise from a breach of debt covenants, e.g. gearing related covenants impacted by deflation on the regulatory asset value (RAV), or the lack of available funds in the capital markets at a time when a PEC needs either to refinance existing debt or to make arrangements for new credit lines.

PRE-ADMINISTRATION ARRANGEMENTS

Question 1 - Do respondents consider the guidance document accurately reflects the individual stages in the pre-administration process as set out Chapter 3? Are there any other stages that should be reflected?

We are broadly comfortable that the guidance document reflects the individual stages in the pre-administration process.

In considering the use of a re-opener as outlined in stage 3, Ofgem will need to give consideration both to the speed of deciding on the details of the re-opener and the speed of access to the additional revenues that may be awarded. If a PEC is in financial distress and likely to head towards special administration then the additional revenues need to be accessed very quickly and be of sufficient scale to make a difference to the PEC's financial health.

Question 2 - Do respondents have any views on Ofgem's existing arrangements for monitoring financial health set out in Chapter 3 and Appendix 4 of the guidance document? Do respondents consider these should be augmented and, if so, in what ways?

Ofgem's approach to the possible financial distress of a PEC has been to be as unintrusive as possible whilst satisfying itself that the regulated entity retains the capacity to continue to serve customers until it has been put onto a more secure footing.

The UK regulatory regime focuses almost exclusively upon the *licensed* entity. It is not generally concerned with the financial strength of entities above or below the licensee. There are neither special requirements nor any criteria that govern who is a fit and proper person to own or control a licensee.

This *laissez faire* approach to the ownership of licensees means that Ofgem places a special reliance upon the regulatory apparatus that focuses upon the licensee itself. The most important part of this is the financial ring fence and the associated regulatory instruments.

The fundamental purpose of the ring fence is to ensure that the licensee uses its assets to ensure that it can continue to meet its duties. As long as the licensee is in good financial health, and subject only to some fairly unintrusive certification requirements, the licensee is left free to manage its own affairs, making its own choices in terms of financing, and it is free to pay dividends to shareholders from distributable reserves. Only when signs of financial distress are apparent do the more onerous requirements, such as the cash lock-up, come into play.

The existing regime was conceived and designed before the credit crunch and it may be appropriate to reconsider its effectiveness in the light of that experience.

Perhaps the most important point to make in this regard is that the present arrangements depend upon two things:

1. the ability of the ratings agencies to detect early signs of financial distress; and
2. the integrity of the directors of the license when providing the certifications of financial health.

With respect to the first of these, there has been considerable criticism of the role of the ratings agencies in the credit crunch and it may be timely for Ofgem to consider, especially in the light of the highly geared ownership structures, whether the reliance that the regulatory regime places upon the ratings agencies is well-founded. With respect to the second, it is not clear to us that, prior to the cash lock-up operating, the present financial ring fencing arrangements are sufficient to ensure that a financially stressed group would not be able to ensure that cash left the licensee before Ofgem was able to block the movement of funds. Such a scenario seems to us not to be entirely implausible. Were it to occur it would certainly test the effectiveness of an enforcement regime that could only act upon the licensee and in which the licensee might have to enforce, possible in a foreign jurisdiction, the undertakings given by the ultimate controller in favour of the licensee. It is possible to conjecture situations in which the cash has disappeared long before the regulator is able to take effective enforcement action secure the financial position of the licensee.

A possible remedy for this might be that the certification process that precedes the payment of dividends might be enhanced for those licensees that are part of groups whose financial strength is questionable. This might be preferable to Ofgem becoming more prescriptive about the capital structure of the licensee or of a group that owned a licensee.

Question 3 - Do respondents have any comments on the existing financial ring-fencing provisions as summarised in Chapter 3 and Appendix 5 of the guidance document? Do respondents consider these are effective? Do respondents consider these arrangements should be augmented and, if so, in what ways?

We are broadly content with the overall ring-fencing provisions. However, it seems to us that the 'Availability of Resources' statement may add little to the protection that is derived from the fact that accounts are signed off on the basis of the going concern principle.

Under this principle, directors have to be satisfied that they have sufficient financial resources to meet the needs of the business for a period of 12 months from the date of approving and signing the accounts. This is very like the annual certification required under the licence. In addition, our experience is that auditors have focussed extensively on this issue during their audit largely in response to direction from Financial Review Panel and the current economic climate.

The accounts of Northern Electric Distribution Ltd (NEDL) and Yorkshire Electricity Distribution plc (YEDL) for the year ended December 2008 contain enhanced disclosures in relation to how the directors formed their view that the companies are going concerns. These additional disclosures will be replicated with respect to the regulatory accounts for the year ended 31 March 2009.

Question 4 - Do respondents have any views on the proposed process and triggers for reopening/disapplying price control as set out in Chapter 4 of the guidance document? Do respondents have any views on potential improvements to these arrangements?

The proposals are reasonable; the emphasis needs to be on the speed of action by both the PEC in trouble and Ofgem.

ADMINISTRATION ARRANGEMENTS

Question 1 - Do respondents consider the guidance document accurately reflects the individual stages in the administration process as set out Chapter 5? Are there any other stages that should be reflected?

No substantive comments.

Question 2 - Do respondents consider that Chapter 6 of the guidance document provides an appropriate summary of the arrangements for appointing an energy administrator?

We consider that the arrangements for appointing an energy liquidator are adequately described although we would consider that they could be enhanced to cover the circumstances where more than one PEC could go into energy administration at the same time. This would place considerable strain on each of the stages and may give practical problems in finding sufficient administrators available who meet the criteria defined in 6.1.

Question 3 - Do respondents consider that Chapter 7 provides an appropriate summary of the key elements of the core administration work?

We consider that Chapter 7 provides an appropriate summary of the key elements of the core administration work albeit at a low level of detail.

The timing of when the distress occurs could have a variety of impacts, for example in relation to the requirement to produce the regulatory reporting pack (RRP) along with audited financial accounts which will need to observe the going concern principles. Furthermore, the impact could be different if the distress occurs during the finalisation of a price control settlement.

Question 4 - Do respondents have any views on the legal, licensing and price control issues identified in relation to the restructuring/sale of a PEC in Chapter 8?

We consider that the issues have been adequately described in chapter 8. However, they need to be enhanced to cover the circumstance where an energy administrator has been appointed and a trade sale then becomes an option. The process needs to be amplified to consider how the sale would be handled and whether the circumstances require that special undertakings be given by the ultimate controller of the entity that is seeking to purchase the distressed or insolvent licensee.

Question 5 - Do respondents consider the arrangements set out in Chapter 9 of the guidance document would provide for the efficient end to an energy administration process?

No substantive comments.

Question 6 - Do respondents consider that Chapter 10 of the guidance document accurately reflects the roles of Ofgem, the Department of Energy and Climate Change (DECC) and HSE in the administration process?

No substantive comments.

APPOINTING AN ENERGY ADMINISTRATOR

Question 1 - Are there any other aspects of the legal framework which should be covered in Appendix 1 of the guidance document?

We consider that the Appendix provides a reasonable overview of the legal framework. However, it needs to be enhanced to recognise the role of the competition bodies (UK and EU) that might need to approve any merger.

Question 2 - Do respondents have any views on the accuracy of the list of PECs and other network operators set out in Appendix 3 of the guidance document to whom it is proposed that document would apply?

No substantive comments other than the ownership data for NEDL and YEDL should now read Berkshire Hathaway, Inc. (89.5%)/Other Shareholders (10.5%) to be consistent with latest US filings.

PROCESS OF ENERGY ADMINISTRATION

Question 1 - Do respondents have any views on the proposed process for finalising the guidance document?

No substantive comments.

In the event that you would like to discuss any of the points raised in our response to the Consultation Document please do not hesitate to contact me on 0191 223 5115.

Yours sincerely

A handwritten signature in black ink that reads "John France". The signature is written in a cursive, flowing style.

John France
Regulation Director