

A large, solid red curved shape that starts from the left edge and curves upwards and to the right, forming a partial arc that serves as a background for the title text.

Review of the 'Ring Fence' Conditions in Network Operator Licences Central Networks' Response

Table of Contents

Contents	2
Exec Summary and response to objectives	3
Ofgem's preferred approach	5
Alternative options considered	8

Chapter 1

Exec Summary and response to objectives

In this chapter we present a summary of our response and provide our views on the review objectives and existing ring fence conditions.

Overall, Ofgem's review is appropriately balanced between risk and cost in their selection of proposals to improve the financial ring fence. They recognise that the current ring-fence conditions have not been demonstrated to have weaknesses, but that they should be updated to recognise the change in organisational and operational structures (e.g. related party and external service providers) and the subsequent change in risk that this brings.

The preferred approach presented in the consultation is broadly reasonable, but we have three main concerns:

1. Firstly, the introduction of independent directors would not achieve Ofgem's objectives and we do not think it necessary to introduce.
2. The widening of the trigger for a cash lock up to include better early warning triggers is reasonable, however more care should be taken that these restrictions do not cause unnecessary lock-ups for events that are not serious.
3. More information is required on the proposed clear sanctions for directors which, although referred to in the consultation, were not dealt with in any detail.

Ch1 Q1: 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?

The consultation paper lays out an overall objective of the review to

- "ensure that they are as robust as possible in light of lessons learned from the recent financial crisis" and
- "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".

Overall these objectives seem reasonable, in light of recent financial and economic events. It is important that the review keeps in mind that the purpose of the ring-fence is to preserve the interest of consumers and to ensure that any new proposals would

genuinely do this, rather than just appear to. It is also appropriate that any final proposals are in proportion to the level of risk to which NWOs are exposed and do not lead to unnecessary costs to deliver the requirements.

The broad objectives of the regime laid out in Chapter 2 also seem appropriate.

Ch2 Q1: Have we identified the key risks associated with any limitations of the existing ring fence conditions?

We are comfortable with the current ring fence arrangements and are not actively looking to change any of these. We do however recognise some of Ofgem's concerns over the weaknesses in the current arrangements, in particular the lack of focus on operational risks and the limited early warning role it plays. We would encourage Ofgem to focus on these areas in its review.

Chapter 2

Ofgem's preferred approach

This chapter answers Ofgem's questions on the preferred approach presented in the consultation.

We welcome the measured approach Ofgem have taken on their proposal, recognising the effectiveness of the current arrangements (as supported by the CEPA report). We do have some concerns over some of the proposals, in particular the requirement for a majority of independent directors, which we discuss below.

- (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.

We recognise that the scope to alter triggers for cash lock-up could be broadened in order to make it more effective and support the move to widen it to include a change in the adequacy of resource statement. However, any triggers as a result of banking covenants should be treated with caution.

Banking covenants can be financial as well as non-financial, e.g. cross default or even covenants to provide information, so a lock up could easily be disproportionate in some circumstances. Any proposals to include bank covenants should be clearly defined to determine the type and nature of the breach to avoid this.

The inclusion to include arrangements in terms to avoid breach seem heavy handed as it might catch a 'technical waiver' and also may have a circular effect in that if a cash lock up is triggered by a change in terms then bankers will not agree to a change in terms.

- (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').

Given the changes in corporate structures and organisational resourcing over recent years, we do not have significant concerns to raise regarding this proposal.

- (c) Clear sanctions where resource adequacy statements are found to be inaccurate or out of date.

Further information is required before this proposal can be properly assessed, including what these sanctions would be and for whom (e.g. licensee, directors?). We welcome further information from Ofgem before any final consultation.

- (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).

We recognise the importance of an NWO's revenue stream in the event of a cash lock-up. It will contribute to the working capital of the business and enable the business to operate with minimal disruption to customers. However, the introduction of this extension will limit the ability of DNOs to finance themselves efficiently. For example, it could restrict the ability to offer them up as contingent assets to pension schemes, which could have a knock-on effect to the cost of schemes. Therefore the appropriateness of this proposal needs to be considered further, as it does conflict with the objective of the review to minimise the impact on NWO management to have the freedom to finance themselves efficiently.

- (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.

In the absence of any evidence that the current arrangements within NWOs have lead ultimately to disadvantaged consumers, the potential cost to consumers of appointing a minimum of typically four independent directors is significant and unnecessary. The current arrangements include operational and managerial separation along with the appointment of a Compliance Officer and appear sufficiently robust. NWOs may consider the risk of a Competition Commission referral sufficiently onerous to dissuade any Director from either not acting in the best interests of the licensed entity to which he is appointed, or generally distorting the market.

Should Ofgem decide that there is sufficient evidence to require NWOs to appoint independent directors, then the suggestion that Ofgem may wish to carry out FSA style "suitability" interviews would require a robust process to avert any accusation that the Regulator was imposing his own choice of candidate on the NWO.

The CEPA report expressed doubts about the effectiveness of this requirement, stating that "We have doubts that the additional non-executive board members are likely to have a significant impact:

- The non-executive directors are still appointed by the parent company (it will pass a resolution appointing them as directors) and could remove them.
- Legally the duties of the non-executive directors are the same as those of the executive directors
- Under company law (in particular the Companies Act 2006) directors have a duty to promote the success of a company for the benefit of its members. Where there are no independent shareholders, it is not clear that an independent director can interpret his or her duty in a different way from an executive director”.

Chapter 3

Alternative options considered

This chapter considers some of the alternative options presented by Ofgem in the consultation.

Less intrusive approach

The ring-fence conditions are important in protecting customers in the event that NWOs suffer financial distress and a less intrusive approach would not be beneficial for customers. The increased gearing adopted by some licensees, and implied in the DR5 settlement has increase the financial risk for NWOs, making a less intrusive approach inappropriate.

More intrusive approach

It should remain the responsibility of NWO management to operate their business efficiently and effectively. Customers will be best served by the Ofgem focussing on better regulation to ensure they bear fair and efficient costs through price controls, rather than focussing on additional reporting on the ring fence.

More stringent regulatory controls

It is important that the ring fence conditions strike an appropriate balance between the risk of financial failure and the restrictions on DNOs to operate effectively and efficiently. The more intrusive options presented in the consultation would not be successful in striking this balance as they would introduce more cost for DNOs and ultimately customers. This cost would arise from the additional cost of reporting and the increased cost of more restrictive financing arrangements, such as the requirement to hold cash.

The proposal for Ofgem to have the right to impose the cash lock-up at its discretion would create significant regulatory uncertainty.

Overall, we think Ofgem has taken the right approach in recognising the limitations of the alternative options presented.