

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

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#### **Executive Summary**

As the sector appears to be emerging unscathed from the recent financial crisis and recession there is every reason to believe that the existing financial ring fence is effective and appropriate. However, the developments in the regulated business model and the shift in recent price controls to gear up regulated businesses (thereby reducing the equity buffer) suggest that a review may be appropriate.

All of the papers published on the current arrangements recognise that the current ring fence has provided significant protection for customers whilst allowing companies to innovate responsibly in order to generate efficiencies. Developments in the sector since the ring fence was established require the scope of the current arrangements to be improved, but there is no compelling reason to undertake significant reform that carries the risk of unintended consequences.

We note Ofgem's concerns that the current ring fence provisions may not provide full protection for customers under specific exceptional circumstances. We suggest that a number of those concerns are already addressed by other means such as obligations under company law and the requirement to provide audited statutory accounts. In particular, the proposed requirement for a majority of the Board to be comprised of independent directors is unnecessary. Ofgem have cited the concern that directors may have conflicts of interest when a parent company is under financial distress but we would confirm that further sanction is unnecessary as this scenario is already covered by Company Law. We maintain that the requirement to explain any non-compliance with the provisions contained in the Financial Reporting Council's Combined Code on Corporate Governance (the "Code") which includes provisions on board composition is adequate to ensure good governance. Furthermore, we propose that the requirement in the water licence for directors to act solely in the interests of the regulated business could be incorporated into the ring fence. Present conditions require the licensee to conduct activities as if it were a publicly traded entity, and suitable governance procedures are embedded in the ring fence to provide an effective independent Board structure.

We agree with Ofgem's proposals for an extension of the annual 'availability of resources' certification to cover operational and contractual controls. We believe that this extension could also address Ofgem's concerns surrounding restrictions on granting security over assets.

## **1 Is there a problem with the current arrangements?**

Ofgem's review of the Regulatory Financial Ring Fence is taking place after one of the most significant economic events in living history. It is important to recognise that the current framework has served customers well in the past and during this period. We can only assume that the framework has been effective as we do not know whether a company would have failed if the measures were not in place. What we can say is that the measures have protected customers whilst maintaining investor confidence in the sector.

The current arrangements have also created appropriate incentives to create responsible financial efficiency in the regulated businesses. It is important to consider this point in the context of the inappropriate incentives in the banking sector and the resulting impact on the global economy. The push to tighten the regulatory controls in that sector is appropriate given the obvious failures.

This consultation is taking place in parallel whilst a review of the regulatory framework (and how it sits within the wider energy sector) is being completed. It is vital that there are consistent and co-ordinated objectives for all of these reviews. In particular, Ofgem has failed to recognise the benefits of the ring fence in the RPI-X@20 project consultation. The proposal within RPI-X@20 to disregard the short term cash ratios threatens the investment grade credit ratings of the network companies, a key component of the Ofgem ring fence.

Ofgem must recognise the evident success of the current arrangements and be careful to only make modifications to the licence where there is a clear need to do so. However, the developments in the regulated business model and the shift in recent price controls to gear up regulated businesses (thereby reducing the equity buffer) suggest that a review may be appropriate.

## **2 Objectives of the ring fence**

Ofgem's objectives for the ring fence include:

- Preventing onset of financial distress
- Providing warning signals to Ofgem
- Mitigating the severity and impact of financial distress
- Facilitating price control reopener measures

We agree that these objectives are appropriate and that the current arrangements should provide significant protection to customers in the vast majority of circumstances. We recognise however that recent developments and innovations in the regulated business models may require a clarification or revision to the existing ring fence.

### **3 Improving the quality of the current measures**

Following the review and stress testing of the financial ring fence, Ofgem has identified a number of concerns with the current arrangements:

- Lack of focus on the operational risk of the businesses
- The cash lock up provides a limited early warning role
- There may be weaknesses in the transfer of funds restrictions
- There may be weak sanctions on directors

Ofgem's proposals to address each of these issues are discussed below.

#### **3.1 Operational risk**

Ofgem has proposed to extend the annual 'availability of resources' certification to cover operational matters including key contracts with network operations contractors. It is important to note that, in complying with the present conditions, clear assessment of operational and similar arrangements is a pre-requisite for the completion of a robust business plan and budget. We agree, however, that the recent move by companies to outsource specific areas of responsibility may not be captured under the existing ring fence. We therefore agree that this extension to the availability of resources certification is sensible.

#### **3.2 Cash lock up**

The proposals discuss a potentially more onerous cash lock up trigger. Under the current licence conditions, a cash lock up is only enforceable as a result of a downgrade in the licensee's rating below investment grade. Ofgem propose to link the cash lock up trigger specifically to gearing and other ratios which effectively tightens the trigger. This proposal stems from Ofgem's concern that the cash lock up mechanism does not provide an early warning signal and that the impact of the downgrade reduces the options available. The analysis fails to recognise that Ofgem has a number of early warning mechanisms in place including the company auditor signing off the statutory accounts as a going concern and the requirement to produce cash flow forecasts as part of the availability of resources certificate. It is possible that additional cash lock up mechanisms may have the unintended consequences of reducing flexibility in financial management and thereby increasing financing costs or deterring investors. We do not, therefore, believe this mechanism is necessary or is beneficial for customers

Ofgem's proposal to link a cash lock-up to the breach or renegotiation of any financial covenant the Licensee may have agreed with lenders is an area that requires particular care. Ofgem should recognise that any existing agreements will have been set around the current framework and that the Licensee may have agreed a number of ratio tests that do not automatically lead to a default.

Lenders to a regulated utility will take comfort from the ring fence provisions and may include restrictions on distributions being made if certain ratio levels are not met. However the financing documentation will include a clear mechanism for remedying

any short-term restrictions. Ofgem's proposal to effectively "piggy-back" on any financing agreement without providing the same clarity around remedies has the potential to significantly complicate the workings of such provisions. This would be unhelpful to maintaining investor support for the sector.

### **3.3 Sanctions for directors**

Ofgem has proposed sanctions and personal penalties for directors who provide inaccurate or non-timely submissions in relation to the financial viability of the networks. Ofgem has noted its concerns that a director of a network operator may act in accordance with the requirements of the holding company rather than the regulated business. This proposal is unnecessary as this scenario is already covered by Company Law which imposes extensive duties on the part of directors including the duties outlined in sections 171 to 177 of the Companies Act to exercise independent judgement and avoid conflicts of interest.

The straw man also includes proposals to increase the number of non executive directors on the Licensee's Board, with a requirement for the majority of the Board to be independent. Ofgem suggests that this requirement would be comparable to the condition already placed on water licence holders. This proposal is inappropriate; it would increase cost, reduce operational efficiency and have a negative impact on the effective decision making of the Licensee. The concern driving this proposal does not warrant such an overhaul to the management and ownership structure of the regulated businesses. The requirements under Ofwat's Water Licence Condition F require that "the composition of the Board of Appointee should be such that the Directors, acting as such, act independently of the parent company or controlling shareholder" and "where potential conflicts exist between the interests of the Appointee as a water and sewerage undertaker and those of other Group Companies, the Appointee and its Directors must ensure that, in acting as Directors of the Appointee, they should have regard exclusively to the interests of the Appointee". This part of the water ring fence does not specifically require a majority of independent directors but requires the management to act as such. Failing to act in accordance with this condition could represent a serious breach in the licence with the associated penalties. Ofgem could mirror the requirement for directors to "act exclusively in the interests of the regulated business" as a sensible alternative to requiring the majority of the Board to be independent.

The Electricity Distribution Licence currently requires a company to include in its regulated accounts a corporate governance statement with the coverage and content of that required to be prepared by a quoted company. This entails complying or explaining any non-compliance with any of the Code's provisions, including those relating to board composition. The Financial Reporting Council state that the Code is published to support good corporate governance which should contribute to better company performance. We maintain that for Ofgem to insist on higher corporate governance principles for regulated companies than for any listed company would be overregulation.

### **3.4 Weaknesses of financial restrictions**

The proposed restrictions on granting security over assets are unnecessary given the extension of the availability of resources certification discussed above in section 3.1.

## **4 Balancing the benefits and risks**

Ofgem has recognised that there is an inherent danger of unintended consequences when placing additional restrictions on the network companies. The success of the current framework and the stress testing of the ring fence suggests that minor adjustments rather than a fundamental overhaul are required.

There is a danger of “over regulation” in response to concerns in other sectors eg banking and financial services. It is important that any developments do not damage investor confidence in the sector.

## **5 Conclusion**

Our key positions in this paper are:

- The current ring fence has provided significant protection for customers whilst allowing companies to innovate responsibly in order to generate efficiencies. Significant and unnecessary changes to the arrangements run the risk of damaging investor confidence in the sector, and we therefore support incremental changes in specific areas.
- We agree with the Ofgem proposals for an extension of the annual ‘availability of resources’ certification to cover operational and contractual controls.
- The cash lock up mechanism is unnecessary as the Ofgem has a number of early warning mechanisms in place, including the company auditor signing off the statutory accounts as a going concern and the requirement to produce cash flow forecasts.
- The proposed requirement for a majority of the Board to be comprised of independent directors is unnecessary and the intended result can be achieved via less intrusive mechanisms including a requirement to “act exclusively in the interests of the regulated business”
- The proposed restrictions on granting security over assets are unnecessary given the extension of the availability of resources certification.