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Dear Paul

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

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ESP Gas Group Ltd ('ESP') operates as an independent Gas Transporter and an independent Distribution Network Operator. It holds four iGT licences and one IDNO licence.

In responding to the above consultation, we question the overall need for the changes Ofgem is proposing, and comment on a number of the specific proposals put forward. As we make clear, if changes to the Ring Fence Conditions are indeed necessary, ESP would favour a light touch approach, with full consideration of the relative cost to each organisation of implementing such proposals.

It is simpler to address our concerns under separate headings rather than attempt to relate them to consultation questions. We would be happy to provide further clarification should you require it. We may also wish to provide further more specific comments on behalf of our investors after the deadline for responses, and hope that you will take any such information into consideration.

Consolidation of Ring Fence provisions across licences

Despite operating four iGT licences, we do not consider that the consolidation of the provisions across multiple licences is currently practical or desirable. Difficulties may arise when deciding where exactly the licence provision(s) should sit, since other group companies may have interests entirely separate to the licensee covered by the ring fence provisions. ESP would prefer to continue with the arrangements as the currently stand.

Requirement for 'living will'

ESP believes that whilst such a provision may be useful in some circumstances, it would be unrealistic to expect the use of a living will, and its associated upkeep, for the day to day operation of an NWO business. It would be an overly burdensome exercise and we believe not actually critical to achieving what Ofgem suggest it would be used for.

Cash lock-up

The cash lock-up provisions are in place to ensure that any NWO which loses its credit rating will have sufficient funds to continue operations. This is not necessary where escrow provisions already exist. ESP assumes that Ofgem does not intend the cash lock-up proposals to apply to those NWOs currently without a credit rating, such as the iGTs and IDNOs which are currently covered by an escrow obligation. There is no reason why there should be any 'doubling up' of the various Ring Fence provisions where they perform the same function, either for the independent operators, or for the incumbent NWOs.

The proposals also seem to suggest that in the case of a loss of credit rating, the parent company may withdraw funds from the NWO. ESP does not believe this to be the case, assuming that the ultimate controller guarantee serves its purpose. We also question whether a renegotiation of a covenant should necessarily trigger cash lock-up. Where such a renegotiation was undertaken in order to avoid breach, then surely this is a course of action that should be encouraged, and, if successful, commended?

But by far the the most crucial point we wish to make is the feedback that we have gained so far from our investors. The view here is that breach of covenant leading to the trigger of cash lock-up provisions would exacerbate, not ease, any instance of financial difficulty. In light of this additional risk to the lender, they believe that a significant increase in the cost of capital to the NWO would be inevitable. This simply cannot be ignored: the impact on investors should be placed front and centre of any decisions Ofgem makes during this consultation. Their ability to act and react is as vital as that of the NWO management. It can be argued that if investors place value on the existence of cash lock-up or equivalent provisions, then it is reasonable to assume that they will insist on such provisions. In turn, NWOs will accept this to secure a lower cost of capital. Such provisions imposed across the board by way of licence, on the other hand, constrain far more than they protect.

Appointment of independent directors

We would ask Ofgem to reconsider the benefits of this proposal. It is an onerous measure, particularly for smaller licensees. Firstly, however, further clarity is required as to whether the proposal intends a majority of independent directors at all times, or in times of crisis only. Paragraph 3.23 proposes an 'at all times' approach, but we are unsure whether this is the intention.

Secondly, ESP is uncertain as to the need for this provision. We would question whether the proposal brings the consumer any further protection at all. After all, if at any point a NWO starts to draw on its escrow (for example), we would expect that Ofgem would already have a great degree of interest in the ongoing operation of that NWO. What evidence has been provided that a large degree of independence on the board of directors will bring about the objectives of consumer protection or regulatory oversight that Ofgem seeks?

The third point we raise relates to the financial burden of this measure, particularly for smaller NWOs. The cost of appointing (potentially at very short notice) and retaining what may be six or seven independent directors is, we believe, wholly disproportionate to the perceived issue. To find this number of people with an appropriate level of experience would be incredibly difficult.

As long as they are of the right calibre, a single independent director should be able to 'ask the right questions'. But is there really a need to make this a licence obligation? Bearing in mind the way that most NWO companies are financed, there is already significant financial scrutiny of the activities of the management, and it is very likely that in line with best practice in corporate governance a degree of independence will already exist at board level. We strongly believe that imposing such an obligation on NWOs would go against Ofgem's stated objective of minimising the impact of these licence conditions on the freedom of the NWO management to organize and finance the business.

In summary, ESP believes that NWOs should not be required to have a majority of independent directors, nor should a minimum number be imposed. This is especially true for smaller licensees, such as the independents. Even for larger licensees we struggle to see the benefit where existing directors are already at liberty to employ independent directors if they perceive it to be to the benefit of the company. Whilst we concede that NWOs can be complex organisations, with significant potential for conflicts of interest, ESP believes that appointing by necessity a number of qualified independent directors would be at once difficult, costly and ineffective to Ofgem's stated purpose.

Sanctions and penalties

The consultation mentions the introduction of sanctions for inaccurate or out-of-date submissions. We are unable to comment on this in any detail without some further clarity on the nature of such sanctions. However, we would point out that alongside such sanctions must sit a robust appeals process and the ability to challenge any such decisions in court.

Operational resource

Whilst financial resource considerations are always straightforward in definition and simple to identify, operational resource impacts can be very difficult to define in a complex business such as an NWO. Even with strong guidelines, the question of whether operational resource constraints are critical will always be open to interpretation. This leads to the risk of inadvertent breach. Or, it could result in 'playing it safe', and Ofgem being inundated with reports of potential breach, which they will then be required to assess. In our view, this proposal is wholly impractical for NWOs to implement, and for Ofgem to administer.

NWOs live with a continual degree of risk relating to the sudden or unforeseen resourcing issues. This is a risk that they mitigate in a variety of ways already. The occurrence of such events must not lead to any Ring Fence provision being invoked; otherwise the efficient choices currently made to mitigate such risks will inevitably be replaced by less efficient practices.

Meter operators

A couple of observations can be made here, one relating to the previous point about operational resources, and a second which is less closely linked with the questions raised by the consultation.

Metering services are crucial to the continued operation of our distribution businesses. Without a functioning meter, we are unable to generate revenue. We realise that it is a supplier obligation to ensure that a meter is in place to measure consumption. Nevertheless, we are uncertain as to the readiness of suppliers to take on the operation or large numbers of meters, should a large service provider go out of business. ESP understands that despite such an occurrence being entirely outside of our control, we would still report this to Ofgem as critical to our operation, and 'pay the price' in terms of restrictions on our ability to finance further operations. Of course, this would be a subjective decision. Other similarly affected NWOs may choose to act differently.

ESP notes in addition that meter operators are not subject to any form of financial ring fence conditions themselves, despite providing a crucial element of the customer's energy supply. Such organisations are as likely to experience financial difficulties as the market evolves, yet no restrictions on their financial requirements are imposed to the benefit of the consumer.

Summary

We accept Ofgem's reasons for reviewing the Ring Fence Conditions and fully support the overall objectives. However, ESP sees no reason why Ofgem, presented with its consultant's review, feels it absolutely necessary to make changes to these financial licence conditions. As Ofgem points out, NWOs have in the last year faced relatively extreme economic conditions and have taken this 'health check' in their stride. We would need to see some more robust justification for the proposed changes before we are able to support them in their current form, in particular because we believe that they are likely to increase perceived risk to lenders, thus increasing the cost of capital.

If you would like to discuss further any of the above points, please do not hesitate to contact me.

Yours sincerely

A handwritten signature in black ink, appearing to read 'D. Speake'.

David Speake

ES Pipelines Ltd.