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Dear Paul,

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

National Grid owns and operates the high voltage electricity transmission system in England and Wales and, as National Electricity Transmission System Operator, we operate the Scottish high voltage transmission system. National Grid also owns and operates the gas transmission system throughout Great Britain and, through our gas distribution business, we distribute gas in the heart of England to approximately 11 million offices, schools and homes.

Through our subsidiaries, National Grid also owns and maintains a large number of domestic and commercial meters, the electricity Interconnector between England and France, and a liquid natural gas importation terminal at the Isle of Grain.

We are pleased to take this opportunity to respond to the consultation on the 'Ring Fence' Licence conditions. This response is in two parts: this opening section provides general comments on the issues raised in and by the consultation, as well as explaining in greater detail why it would not be justified or beneficial to create a licence requirement for independent directors on the boards of NWOs[1], and there is then an Appendix which considers some of the specific questions that are raised in the consultation.

General Comments

The existing statutory regime for dealing with NWOs in distress, the ring-fencing provisions and general duties on directors under the general law and Companies Act 2006 ("CA 2006") are sufficient to ensure network provision and customer protection in the event of potential or actual financial distress without the need for new requirements that would interfere with the corporate governance of NWOs. The existing regulatory ring-fencing provisions are far reaching and there is no evidence that they have failed to date. Indeed Ofgem recognises in its consultation document that "all NWOs have come through the recent financial crisis without succumbing to financial distress" and therefore by implication concedes there is no evidence to suggest that existing ring-fencing provisions are not working (or would not work) to ensure network provision and protect customers.

[1] Consistent with the definition in the consultation, the term NWO is used in this response to refer to the person (a corporate person, i.e. company) that holds the relevant electricity transmission, electricity distribution or gas transporters licence. NWOs include owners of gas and electricity transmission and distribution networks (including independent network operators).

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We recognise the important role of the ring fence conditions, in ensuring that the assets and resources of the licensees are properly applied to meet the needs of the regulated business for the benefit of consumers, especially by contributing to the information that Ofgem receives to help it monitor the financial position of the companies. Different stakeholders will value the contribution that these conditions make as part of the overall regulatory framework to the stability and reliability of the industry as a whole. The individual conditions can also have specific additional benefits: importantly, the licence requirement for licensees to maintain an investment grade credit rating is valued by investors (both debt and equity) who can rely on the NWOs maintaining this rating. This also helps them to have confidence that Ofgem will set price control revenue restrictions in such a way that efficient licensees will have sufficient revenues and cash-flows to maintain an investment grade rating while providing reasonable returns to equity investors.

Notwithstanding these benefits, the ring fence conditions need to be seen within the context of the overall framework of energy network regulation in the UK (as well as other relevant parts of our legal system and corporate governance framework). This is an incentive-based framework, which relies on the NWOs being incentivised to operate efficiently and, where appropriate, to innovate, in meeting their obligations and in providing the services that current and future consumers desire, *and requires them to have the freedom to choose the best way of doing so*. In this way the incentive based framework brings benefits to consumers. This model also provides for financial disciplines to be imposed on the companies through private ownership and the capital markets. Particularly with the move towards more outputs-focused price controls which is envisaged under RPI-X@20, interference in the management, operation, financing, and structure of the businesses by an economic regulator should be kept to a minimum. Any extension to the robust and effective ring fence conditions already in place must, therefore, be considered very carefully before being implemented.

The ring fence provisions need to be seen as forming just one part of Ofgem's overall approach of "defence in depth" to managing the risk of financial distress. Given this approach, there is no need for Ofgem to seek to rely on the ring fence conditions alone to address all likely circumstances of financial distress.

In the October 2009 document[2], the approach was described as having the following stages:

- monitoring financial health;
- financial ring fence;
- price control re-opener;
- trade sale;
- energy administration.

Of course, within the overall framework there is another very important element of "defence in depth" which precedes the above 5 stages: this is the way in which in price controls are set by Ofgem. Price control revenue restrictions must recognise Ofgem's statutory financing duty[3], embody reasonable calibration of the various risks and incentives measures, provide a reasonable package overall, and must be acceptable to the relevant NWOs (or otherwise be subject to review by the Competition Commission). Combined with capital market discipline, which will ensure that any underperformance is dealt with promptly and before financial distress is likely to arise, these considerations reduce the probability that financial distress will arise for reasons within the control of NWOs, and Ofgem can be expected to consider price control revenue restriction re-openers if distress were to arise in other circumstances (such as an exogenous shock), as the quickest and most effective way of protecting consumer interests.

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[2] Ofgem guidance document "Arrangements for responding in the event that an energy network company experience deteriorating financial health", 12 October 2009 (Ref 123/09)

[3] Ofgem's recent "Embedding Financeability" (Ref 6/10) consultation explained that it followed from this financing duty that "efficient well-managed network companies should be able to finance and be appropriately remunerated for delivering their activities" and that a key part of the current regulatory framework is to make sure that "efficient network companies … can secure financing in a timely way and at a reasonable cost".

It should also be noted that Ofgem already receives very extensive information on licensees from a range of sources and does not need to rely for forewarning of financial distress on information that is provided only as a consequence of the ring fence conditions. This additional information includes the extensive information that is provided on an annual basis through the Regulatory Reporting Pack (RRP), which has been further extended for the reporting of 2009/10 information. In addition, the October 2009 decision document[4] explained that Ofgem also collects and assesses a range of other information, including share prices and credit ratings, to keep an up-to-date record of the financial position of licensees. Company annual reports and accounts, and particularly for listed companies the continuous disclosure regime of the Financial Services Authority's Disclosure and Transparency Rules, as well as the Regulatory Report and Accounts, also provide extensive information on the financial and operational position of the companies. Clearly, these additional sources of information complement and augment the information that is provided in accordance with the ring fence conditions.

It is noteworthy that all the NWOs have continued to perform effectively throughout the recent financial crisis under the current regulatory framework and existing ring fence conditions without experiencing major financial difficulties. With this track record, within the broader context of UK regulation (including the "defence in depth" approach described above), and in the light of the discussion of each of Ofgem's concerns with existing ring fence conditions under Chapter 3 Queston 3 below, there appears little case for making changes to the existing conditions. It is also not clear that there is any case or need to make changes now, and it would seem more appropriate to wait until after the conclusion of the RPI-X@20 review, when any proposed changes can be considered in the broader context of the new framework.

The preferred approach described in the consultation in Chapter 3 is for a package of changes which, with the exception of the proposal to introduce a requirement for non-executive directors on the Boards of NWOs which is considered in detail below, form an incremental extension to the existing conditions. These separate elements are considered below in the answer to Question 3 Chapter 3. If Ofgem were to proceed to implement these measures, this should be done in a way which seeks to avoid unnecessary burden on the licencees and avoid increases in costs arising from the imposition of unnecessary restrictions on the companies. The consultation recognizes that the additional costs (both direct and indirect) that would result from the changes will need to be passed on to consumers and, as a result, even if changes were to be made, such changes should not be implemented until the next full price control revenue restriction is set.

However, our main concern with the "preferred approach" in the consultation is with the proposed introduction of a requirement for independent directors on the boards of NWOs, which is both unjustified and unnecessary (particularly for NWOs owned by listed companies). We also consider this approach would be detrimental to the currently established effective, efficient and focused management of the NWOs. Our reasoning and concerns with this aspect of the proposals are explained in the following section.

The proposed requirement for independent directors on the Boards of NWOs (either a minimum number or a majority)

National Grid believes that the requirement for the boards of NWOs to have either a majority of independent directors or even a minimum number would be wholly unwarranted. Existing company law and sector regulation provide sufficient protection. In addition where a NWO's parent company is publicly listed, there are additional corporate governance requirements (the Combined Code and the appointment of non-executive directors) which serve as additional protections not only for the publicly listed company but also for its subsidiaries. A requirement for NWOs to have independent directors would impose additional cost on NWOs and could have other unintended consequences, including the complexity and confusion caused by having non-executive directors at two levels (the NWO and listed

[4] "Arrangements for responding in the event that an energy network company experiences deteriorating financial health", decision document, October 2009 (Ref 123/09)

company). This is clearly undesirable (i) at a time when all stakeholders, in particular government and consumers, have clearly indicated their desire for these entities to operate as efficiently and effectively as possible; (ii) where there are clear statutory and other protections already place, and (iii) where there is no substantive evidence of failure in the existing regime and its controls.

It should be noted that the assertion in the consultation paper that the water industry regulation already contains a similar provision is unfortunately incorrect: the water regulatory licences require at most three independent non executive directors and in no case a majority[5].

The suggestion that a majority of directors should be required to be non executive is wholly misguided. The NWOs are significant businesses (both for the economy and their owners) and their stewardship is complex. To so fundamentally break the link between the executive management and ownership, by placing board control at the subsidiary level in the hands of parties independent of both would be a recipe for inefficient stewardship and a lack of cohesion, and could have unintended consequences.

Similar strong arguments can also be set out in relation to the potential requirement to have a minimum number of independent non executives.

National Grid recognises Ofgem's objective to ensure that NWOs have sufficient resources to meet the needs of the company in order to protect consumers in the event of financial distress. However, situations of financial distress are the exception and not the norm. These situations can be dealt with, ultimately, under the special administration regime under the Energy Act 2004, so that security of supply is maintained and consumers protected. It would therefore be disproportionate to impose, at all times, special corporate governance requirements that are only needed for exceptional circumstances, where:

- there is already a set of ring-fencing provisions in place that have worked to date
- there is a special administration regime that is designed to deal with insolvency situations in a way that the continuity of the business is guaranteed; and
- it is not clear how the presence of such independent directors would provide any additional protection to consumers, when the fiduciary duties of directors are set out already in statute.

Indeed, the general duties of directors also provide substantial and sufficient protection with regards to NWOs' operations. Ofgem's objectives for the proposed introduction of independent Directors at NWO level (specifically described in the consultation as being to guard against conflicts of interest, but perhaps also reflecting a wish on Ofgem's part for consumers' interests to be taken into account) are already reflected adequately in the general duties of Directors. Directors' duties are codified in sections 171 -177 of the Companies Act 2006 (some of which took effect from 1 October 2007 and some from 1 October 2008). In particular, these include, amongst others, the duties:

- to act in the way the directors consider most likely to promote the success of the company for the benefit of the members as a whole;
- to exercise independent judgment;
- to exercise reasonable care, skill and diligence; and
- to avoid conflicts of interest.

Whilst there is a duty to promote the success of the company for the benefit of the members as a whole, the directors must have regard to long term and wider factors, namely employees, suppliers, customers and the impact of the company's operations on the community and the environment, the company's reputation for high standards of business conduct and the need for fairness between members, which the explanatory notes to the CA 2006 call the "enlightened shareholder value". Explanatory note 328 provides that "it will not be sufficient to pay lip service to the factors, and, in many cases the directors will need to take action to comply with this aspect of the duty". This means that under existing fiduciary duties directors must also take into account the interests of consumers.

[5] Except for Welsh Water which is owned by Glas Cymru, a single purpose company with no shareholders which is run solely for the benefit of consumers. Given this ownership structure, different representation at appointee board level is to be expected.

In defining the duties of directors, the Companies Act does not differentiate between executive and non-executive directors: the same duties apply to both, and non-executive directors of NWO subsidiaries would need to take decisions on the same basis and within the same frame of reference as executive directors. The consultation recognises that there is no reason to believe that existing NWOs directors do not perform their duties in accordance with the requirements of companies legislation but refers to the possibility of situations where conflicts of interests could arise (e.g. where the wider group is in financial distress). It should be noted that directors are under a statutory duty to avoid actual or potential conflicts of interests with the company. Directors of the NWO operating companies who are also directors of the parent company or report to the parent company's board would still have an "independent" duty vis-à-vis the NWO to avoid conflicts of interest. An actual or potential conflict of interest can be authorised by the board, but a director cannot be counted in the quorum of the meeting/vote where his conflict of interest is being considered. While there is no legal requirement, once a conflict has been authorised, it is best practice for the concerned director to abstain from voting on that transaction.

Within the framework of UK company law, a requirement to have non-executive directors is essentially one that is applicable to publicly listed companies, where the requirement was introduced to protect the interests of shareholders, who, in the case of publicly listed companies, are diverse and dispersed. Not all NWOs operate in the same way and there are important differences between their wider corporate groups, but where a NWO's parent company is publicly listed there are additional corporate governance requirements (in particular the Combined Code on Corporate Governance in relation to the appointment of suitably qualified and experienced directors and a majority of non-executive directors) which serve as additional protections not only for the publicly listed company but also for its subsidiaries. For example, the statutory duty in relation to promoting the success of the company (and having regard to its customers) would be meaningless at the listed company level if it is simply a holding company that does not have direct customers (i.e. only its subsidiaries have customers as such). Accordingly, the directors will need to have regard to the interests, amongst others, of customers, employees, and suppliers of the subsidiaries when considering this duty. In relation to NWOs, the "ultimate controller undertaking" provides a further link between the parent company (which in the case of UK listed companies is subject to the Combined Code and the requirement for a majority of independent directors) and the licensee, reinforcing the comfort that can be drawn from the governance applied at ultimate holding company level.

Whilst it is true that only publicly listed companies are subject to the Combined Code it is clearly understood that the obligations of those companies' directors are fulfilled by reference to the way in which the listed company's board direct the business and operations of the subsidiaries. The decisions and role of the non-executive directors at the listed company level extend to the business as a whole and will take into account the status and performance of subsidiaries (including NWOs). There is no need for each company within the group to be subject to the same requirements of the Combined Code in order for the Code to have relevance for that group.

Whilst the Companies Act does not differentiate between executive and non executive directors in defining their duties, the Combined Code acknowledges that the time devoted to a company's affairs is likely to be less for a non-executive director than for an executive director and the detailed knowledge and experience of the company's day to day affairs that could reasonably be expected of a non-executive director will generally be less than for an executive director. Non executive directors generally bring other skills and experience and are seen as having a role in relation to amongst other things:

- challenging and helping to develop proposals on strategy;
- scrutinising the performance of management in meeting agreed goals and objectives
- appointing, removing and setting the remuneration of executive directors; and
- satisfying themselves the integrity of financial information and that financial controls and systems of risk management are robust and defensible.

Within a parent/subsidiary group structure, where the parent is a UK listed company, these responsibilities can most effectively be discharged by the majority of non-executive directors on the board of the parent, whose decisions and role clearly extend to and encompass subsidiaries.

National Grid plc is a FTSE 100 company with a turnover of around £15 billion for year ending 31 March 2009. It seeks to appoint executive and non-executive directors who have the appropriate skills and experience for their respective roles. The non-executive directors on the board of National Grid plc, as is to be expected, take an active approach to their duties and responsibilities. These include oversight roles in relation to the UK NWOs within the group. This occurs effectively and consistently with UK best practice. The suggested requirement for non executive directors at NWO level is therefore unnecessary. Moreover, such a requirement, if it were introduced, would inevitably raise questions about the interaction of those roles with those of the independent non executive directors at group level. It would not be in the best interests of good governance to have such overlap and confusion, and consequently the proposal is not just unnecessary but also unhelpful and indeed potentially counter-productive.

As Ofgem recognises in paragraph 2.24 of the consultation document, independent directors in other contexts have not always been able to spot or prevent financial predicaments. In their report for Ofgem[6], CEPA acknowledges that "We have doubts that the additional non-executive board members are likely to have a significant impact" and "Under company law ….. 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."

That said, if Ofgem were to seek to introduce a requirement for independent directors on NWO boards, we do not see there is any benefit in appointing a majority of independent directors to NWO boards.

From the above discussion, it can be seen that there would be no clear added benefit from having independent non-executive directors in NWO boards, and such a regulatory interference in companies' corporate governance would be disproportionate given (i) that there is no evidence that the existing ring-fencing arrangements would not work in situations of financial distress; (ii) that directors of NWOs have general fiduciary duties under the Companies Act that mean that they would take into account the promotion and success of the company, including having regard to its customers, and must avoid conflicts of interest; and (iii) that where the parent company is publicly listed and subject to the Combined Code itself there is an additional set of protections which, together with the other licence and regulatory requirements already in place, are sufficient to ensure security of supply and customer protection in financial distress situations. The consultation paper contains no real justification for such a significant interference in the current arrangements. It is in the interests of all stakeholders and market participants for NWOs to operate efficiently in order to discharge their statutory and regulatory obligations effectively, and such a modification would represent a serious backward step in the regulatory process.

Conclusions

In conclusion:

- The ring fence provisions are seen as having a role in ensuring that the assets and resources of licensees are properly applied to meet the needs of the regulated business and in contributing to the information that Ofgem has to help monitor the financial position of the NWOs. The existing ring fence conditions are appropriate to these objectives.
- The ring fence conditions need to be seen in the context of the overall regulatory framework, which is an incentive based framework within which licensees must have appropriate freedom over the way in which they choose to manage, operate, finance and structure their businesses.
- The ring fence conditions must also be seen as forming just one part of Ofgem's "defence in depth" approach to managing the risk of financial distress.
- The consultation provides no real justification for making changes to the existing conditions: within the overall regulatory framework and context, a reassessment of "worst case scenarios" that was

[6] "Assessment of Ofgem's Financial Ring Fence Conditions – a report for Ofgem", Cambridge Economic Policy Associated Ltd, October 2009, section 7.6.

prompted by the recent financial crises (through which all the NWOs came through unscathed) does not form the basis of a compelling case to make the changes proposed.

- The preferred option consists of a limited number of changes to the licence ring fencing conditions: though these changes are not in our view either necessary or justified, they could *mostly* be implemented at reasonable cost and without undue administrative burden on the licensees, provided they were implemented in a way which avoids the most significant increases in costs (including financing costs) that could be caused. The consultation recognises that the costs resulting from any changes will need to be funded by consumers. Given that there is no pressing need for any of the changes proposed, no amendments should be made to the ring fence conditions until the licence changes following the next round of full price controls are implemented, and only then where the case can be made that such changes will provide a clear cost benefit to consumers.
- The proposal to introduce a requirement for independent directors (either a minimum number or a majority) is completely unjustified (particularly in the case of NWOs that are subsidiaries of UK listed companies subject to the Combined Code). This proposal would not be in the interests of effective management of the companies and good corporate governance, fails to recognize the existing duties of directors, and in some cases would be positively detrimental to effective governance.

We would be happy to expand on any of the points made above.

Yours sincerely,

[by email]

Paul Whittaker
UK Director of Regulation

Appendix – Comments on Specific Points and Questions raised in the Consultation

Please note: the comments in relation to these questions should be read alongside the general comments included above in the first part of this response.

CHAPTER: One – Introduction and Objectives

Question 1: Do you think we (Ofgem) have identified the relevant objectives in our review of the ring fence? If not what other objectives should we be considering?

The overall objective of the review of the ring fence conditions is said to be "to ensure that they are as robust **as possible** in light of lessons learned from the recent financial crisis", but at the same time "**to minimize** any impact on the freedom of NWO management to organise and finance their business efficiently …." (consultation paragraph 1.13). These two objectives are clearly incompatible, and the objective should be redefined to reflect the need to balance these objectives. In fact, at paragraph 3.1 the objective is redefined to be "to improve the protection they [the ringfence provisions] provide to consumers and to promote the financial and operational stability of NWOs." Since this financial stability depends on the ability of NWOs to have access to finance, it is conditional on returns being available to providers of finance (both debt and equity), and as a result financial stability could be hindered by overly restrictive ring fence conditions. The need to balance different considerations does follow from the consultation, though it is inadequately developed or taken account of within it.

At paragraph 1.12, the consultation makes reference to the importance that finance providers attach to the ring fence. However, it would be wrong to imply from this that extending or strengthening the ring fence provisions would be positively welcomed by all finance providers. The main relevance is that finance providers can rely on Ofgem setting price control revenue restrictions for NWOs in a way that is consistent with the ring fence provisions, which (most importantly) means they must provide sufficient revenues and cash flows for the NWOs to maintain an investment grade credit rating.

An important objective of the review should be that it does not result in an increase in the cost of capital, for example as a result of changes which undermine regulatory consistency or otherwise increase the perceived level of regulatory risks, or by unnecessarily constraining the payment of returns to investors, as increases in the cost of capital would not be in the interest of consumers. It should be recognized that investors place value on stability of the regulatory framework.

The general comments above provide further comments on the context in which the ring fence conditions should be considered.

CHAPTER: Two – The existing ring fence and issues arising

Question 1: Have we (Ofgem) identified the key risks associated with any limitations of the existing ring fence conditions?

In Chapter 2 Ofgem identify four concerns they have with the existing ring fence conditions. In considering whether there is any need to address these concerns, it is important to bear in mind that, as Ofgem acknowledge at Paragraph 2.26 of the consultation, "all NWOs have come through the recent financial crisis without succumbing to financial distress …..".

Considering each of these four concerns in turn:

1) Lack of focus on operational risks

Whilst the existing "Availability of resources" certificate submitted to Ofgem may only refer to the sufficiency of financial resources, the licence condition that gives rise to the certificate is far wider in focus and requires the licensee to act at all times in a manner calculated to secure the availability of

such resources including (without limitation) financial resources to enable the licensee to properly and efficiently carry on its licensed activities. The licensees will be mindful of this licence requirement. Moreover, in seeking to run their businesses effectively, in line with good practice and under the disciplines imposed through private ownership and the capital markets, licensees must pay attention to all aspects of their business, and in ensuring they have sufficient resources do not focus solely on the availability of financial resources. There is no reason to think that NWOs give insufficient focus to operational matters. In addition, the Combined Code requires the boards of listed companies to maintain a sound system of internal control which includes a risk management framework that requires the identification, assessment and mitigation of potential risks, including operational risks.

For these reasons, whist the ring fence conditions may not require certification that adequate "non financial" resources are being maintained, a focus on the full range of potential operational risks will always be an important consideration of the management of any business, including NWOs, and the "availability of resources" condition does oblige focus to be given to such resources. Accordingly the ring fence conditions do not need to be extended to cover this issue.

2) Limited early warning role

It is clearly in the interests of all stakeholders, including consumers, for Ofgem to become aware at an early stage if NWOs were to encounter financial distress, as Ofgem would then have the greatest range of options available for dealing with the situation, which would be likely to minimize the adverse effects for both the NWOs and consumers.

The potential limitations of the existing provisions in this respect are considered in the consultation in two parts:

- the first relates to the lack of focus on operational issues in the current adequacy of resources statement. However, as explained above, the issues of which Ofgem is mindful here are matters which are already priorities of company management, who will be able to anticipate and identify any developing concerns that might arise more quickly than any prescriptive ring fence provisions could. As explained in the "Context" section of the consultation, companies can be expected "to act responsibly and to inform Ofgem at the earliest stage possible of any potential or actual financial distress. The earlier that a case of financial distress can be identified, the more response options [Ofgem] have available that may help to mitigate and/or contain the situation."
- The second aspect concerns the circumstances for triggering a "cash lock-up", and is considered under "restriction on indebtedness" in the response to Question 3 below.

Neither of these considerations forms a firm basis for concern that Ofgem would not have reasonable early warning of potential financial distress, but it is also relevant that, as explained in the opening section of this response, Ofgem receives and monitors a variety of information from different sources in relation to the NWOs.

3) Weaknesses in the indebtedness and transfer of funds restrictions

This item is considered under Question 3 below.

4) Weak sanctions on directors

Our opening general comments present our detailed response to the proposal to introduce a requirement for independent directors on NWO company boards, and explain why such a move would not be justified and could have unintended adverse consequences. In addition, the concern that is expressed that directors might face pressure from their parent company is unfounded, given (i) the existence of independent directors on parent company Boards (at least for listed companies) and (ii) the "ultimate controller undertaking" requirement within the existing ring fence conditions. We note that Ofgem acknowledge that there is "no reason to believe that existing licensee directors do not perform their duties in accordance with requirements of companies legislation."

CHAPTER: Three – Ofgem's preferred approach

Question 1: Do you think we (Ofgem) have set out enhancements to the ring fence regime that mean it would meet the identified objectives going forward?

See question 3 below.

Question 2: Do you think our (Ofgem's) preferred approach places the right emphasis on the responsibilities of NWO directors and managers?

Under the energy network regulatory framework within which NWOs operate, directors and managers of the companies are responsible for the management of the businesses rather than Ofgem. With the exception of the proposal to require independent directors, the preferred approach consists of a set of limited extensions to the existing ring fence conditions which may not overly interfere with these responsibilities, though they will cause some administrative burden, some increase in costs and they will place some restrictions on the management and operation of the businesses. However, the proposal to require independent directors is not justified and should not be adopted.

Question 3: What are your views on the changes we (Ofgem) have suggested to the various ring fence conditions? What additional costs might they impose on licensees?

Considering each of the proposed amendments under the "preferred approach" in turn:

- Availability of resources requirements - under this condition, two changes are proposed under the "preferred approach":
  - Extending the scope of the annual availability of resources certificate to cover all resources, not just financial resources: the existing licence condition already requires licensees to maintain sufficient resources to carry on their businesses, so in principle extending the certificate to cover operational resources as well as financial resources would not, at first sight, seem unreasonable or overly burdensome. However, the term "operational resources" used to extend the scope of the certificate must be properly defined, and it would be unreasonable for licensees – or their managers and directors – to be held responsible for any deficiencies in resources that were outside of their control or knowledge.
  - A requirement to maintain (though not to submit to Ofgem) a 'living will' record of key financial and contractual arrangements: we believe it would be good practice for NWOs to have adequate records of key financial, operational and contractual information and agree with Ofgem that existing records will already cover much of this ground for many companies. This requirement would also, at first sight, seem not unreasonable or overly burdensome provided that the intended scope of such key financial, operational and contractual information is tightly defined. The requirement should not, though, be introduced in a way which forced licensees unnecessarily to amend or duplicate existing practices, processes and reporting mechanisms: this would be a risk if Ofgem required records to be submitted, or was to prescribe the form that the records should take.

- Disposal of relevant assets condition: under this condition, the "preferred approach" is to extend the restriction on granting security/charges to cover the NWO licensee's debtors. We do not know the extent to which licensees grant security over their debtors, but we believe this is an option which is generally available to companies in raising finance. Under the incentive-based regulatory framework within which NWOs operate, and as investors place value on stability of the regulatory framework, Ofgem should exercise caution before making changes which would impose restrictions on the NWOs which do not apply to companies in general.

- Clear sanctions where resource adequacy statements are found to be inaccurate or out of date: this amendment is not explained, and it is not clear who the sections would apply to, nor in what circumstances. Paragraph 3.9 of the consultation acknowledges the conscientious approach to compliance with the ring fence conditions that has been adopted by NWOs, and that directors' responsibilities are already underlined by legislation covering issues of personal liability and

disqualification for misconduct. In addition, it would seem unreasonable to hold directors responsible for minor inaccuracies where they could not reasonably have been expected to know of an error or deficiency. For these reasons, we do not support the proposed amendment at this stage, in advance of it being better explained and more fully justified.

- Requirement to hold an investment grade credit rating: the consultation recognises the importance of holding an investment grade credit rating in avoiding increases in the cost of debt, which would need to be passed on to consumers. Investors (both debt and equity) value this licence requirement and also the need for Ofgem to take account of this requirement in setting price controls. The condition remains appropriate and no changes are proposed to it under the "preferred approach" in the consultation.

- Restriction on indebtedness and transfer of funds: under the "preferred approach" the trigger for the cash-lock up provisions would be widened to include (i) "any report by the licensee of adverse circumstances under the availability of resources condition", and (ii) "any breach of a formal financial covenant entered into by the licensee, or renegotiation of such a covenant for the purposes of avoiding a breach." In practice, any breach under (ii) above could cause the acceleration of the debt repayment and/or have a negative impact on the credit rating which could automatically have an effect on the available distributions anyway. A cash-lock up for breaches of financial covenants and the renegotiation of them triggered for example by changes in accounting standards, would be unmerited if the fundamental strength of the company is unchanged. In relation to (i), the meaning of "adverse circumstances" is not explained: if it refers to any deterioration (however slight) in relation to issues covered by the "availability of resources" condition it is clearly excessive and inappropriate, but if it refers only to a sufficiently material change in circumstances for the licensee to no longer have the reasonable expectation expressed in their most recent certificate, the proposed change in (i) above is not unreasonable. However, even with this latter interpretation, there is a risk that unintended circumstances, such as a change in accounting rules, could be captured and Ofgem would clearly need to re-assure the industry that the revised condition would not apply in such circumstances. As a result, any implementation of this change should be drafted carefully to avoid undesirable and unintended outcomes.

- Restriction on activity and financing ring fencing: we agree that no changes need to be made to this condition

- Ultimate controller undertaking: this condition is considered under question 5 below, although no changes have been proposed to this condition under the "preferred approach".

- Requirement for appointment of independent directors: this proposed amendment is considered under question 4 below.

Question 4: Do you agree that NWOs should be required to have a majority of independent directors or should the requirement refer to a minimum number? Should any licensees be exempted from such a requirement?

The proposed requirement for independent directors (either a minimum number or a majority) is not justified and would not be beneficial, as explained in the opening section of this response. It would be particularly inappropriate where the parent company of the NWOs is a UK listed company subject to the Combined Code on Corporate Governance, where it would be likely to be detrimental to effective governance and could have other unintended consequences.

Paragraph 3.23 of the consultation refers to the licence condition of (electricity) distribution businesses which requires independence (Standard Condition 39 in the Electricity Distribution Licence consolidated to 11 August 2006). This licence condition is concerned with separation of the distribution business from any relevant shipper and supplier. This condition gives no reason for introducing a requirement for independent directors.

Paragraph 3.25 invites comments on the level of qualification/experience that independent directors might be expected to have. For the reasons given above, we do not believe that a requirement for independent directors (either a minimum number or a majority) is justified, particularly where the NWO is a subsidiary of a UK listed company.

Question 5: Do you think that ultimate controller undertakings should be re-submitted at periodic intervals?

We do not think that the ultimate controller undertaking needs to be submitted at periodic intervals, as the board of the ultimate controller remains conscious of the undertaking and its obligations, which in any case are aligned to the decision making frame of reference in responsible companies. The undertaking also needs to be re-submitted following a change in the ultimate controller.

If Ofgem was minded to introduce a requirement for periodic re-submission of the undertaking, this should be by way of a "long-stop", perhaps at the commencement of each price control period, rather than an annual requirement.

Question 6: Do you think that the arrangement of ring fence conditions ought to be consolidated within/across licences?

We see no need for such a consolidation, although this could be included in any more fundamental review of the licences

Question 7: Do you agree that changes to ring fence requirements should not be retroactive?

Given the limited need for changes that are identified in the consultation, there is no need for any changes that are made to be retroactive, and in fact it is unclear how the proposed changes could be made retroactive even if this was seen as desirable. As a matter of fundamental principle, retroactivity of obligations should be avoided as being contrary to the Rule of Law. Furthermore, given the nature of some of the changes, it is hard to see how such retroactivity would not put licensees in licence breach, which is wholly unjustified, unjustifiable and unjust

Question 8: Do you think that any of the proposals should be varied for different types of licensee, in particular for independent distributors?

Whilst the overall objectives remain the same for all the licensees, as recognized in the consultation at footnote 7 the specific circumstances of independent distribution companies should continue, where necessary, to be reflected in the ring fence conditions. However, it is not clear that any of the proposed amendments, if they were implemented, should be varied for independent distributors.

If Ofgem were minded to proceed to implement a requirement for independent directors in spite of the strong reasons explained above why this should not be introduced, either an exemption should be granted to those NWOs that are subsidiaries of companies that comply with the requirements of the Combined Code of Corporate Governance, including those NWOs that are subsidiaries of UK listed companies, or the rules contained in the licence amendment should be developed in a way that reflects the additional governance requirements on them.

CHAPTER: Four – Alternative options considered

Question 1: Do you agree that these are the other broad options for change which could be considered or do you think there are additional options?

We agree that the alternative options to the "preferred option" in the consultation are to retain the existing conditions, to take a less intrusive approach, or to take a more intrusive approach. However, within each of these latter two options, there are a range of possible variants: for example, under the

less intrusive approach, it would not be appropriate to remove a requirement for NWOs to maintain an investment grade credit rating, for the reasons explained in the initial section of this response.

We do not agree that the "do nothing" option can simply be dismissed as a result of the re-assessment of worst case scenarios which was prompted by the recent financial crisis, given that, as the consultation acknowledges, the NWOs all came through the crisis unscathed. In this context, the "Do nothing" option is very much a viable option against which the preferred alternative should be compared.

Question 2: Do you think we (Ofgem) have attached appropriate weight to drawbacks which might be associated with the 'back-stop' measures of price control reopening and special administration?

The drawbacks that are described appear to consist of the possibility that, by relying on these measures, there could be an adverse impact on consumers as a result of higher network charges. Where implemented following a price control re-opener, they would merely reflect the underlying costs (including financing costs) of providing the services to customers/consumers, and in these circumstances a re-opener should equally be applied under the existing approach or "preferred approach". It would therefore, be wrong to attach any weight to the increase in charges that might follow a price control re-opener.

Question 3: Do you think we (Ofgem) have attached the right cost/benefit arguments to the less/more intrusive options?

The consultation identifies few drawbacks with the less intrusive option, particularly in the light of the response to question 2 above. However, some investors and stakeholders may value the existing ring fence conditions, particularly the requirement for licensees to maintain an investment grade credit rating, and consistency is important in maintaining confidence in the regulatory framework. For these reasons, it is probably preferable to retain the existing ring fence conditions than to adopt the less intrusive options.

The more intrusive option is considered under question 4 below: it would impose significantly greater constraints and costs burden on NWOs than the existing approach or Ofgem's "preferred" approach, and for these reasons it should not be the approach that is adopted following the review.

Question 4: Do you have any comments on the more stringent regulatory possibilities identified in this chapter?

The proposals relating to cash lock-up would appear to impose unreasonable additional constraints on the NWOs, which would restrict their freedom to choose how best to finance and organise their business efficiently and could increase the cost of capital to the detriment of consumers. It would not be appropriate for Ofgem to have the right to impose additional constraints on a subjective basis and this would also increase the level of regulatory risk and the cost of capital.

The proposed changes in relation to the availability of resources condition are not consistent with Ofgem's role as economic regulator of the industry.

We agree that a requirement for NWOs to hold sums in reserve facilities would be a disproportionately expensive way of addressing a relatively low risk, particularly for larger companies, and so would not be in the interests of consumers. We also agree that the options considered for additional restrictions on disposal of assets would be overly restrictive and that additional restrictions of activity would have an unreasonable regulatory impact.

The current ultimate controller undertaking is very clear in its meaning and places appropriate requirements on the ultimate controller: to change the wording to require an undertaking positively to take actions to ensure that the licensee would not breach its licence obligations would be less well defined and as a result would be unreasonable and difficult to enforce.

It would not be appropriate for Ofgem to propose requirements with regard to the qualifications and experience of NWO boards. The Companies Act sets out the standard of skill and care the directors are required to exercise in discharging their responsibilities. In addition, for listed companies, the Combined Code provides that Non Executive Directors should have relevant skills and experience.

CHAPTER: Five – Impacts, cost and benefits

Question 1: Do you agree that the measures suggested in Chapter 3 (Ofgem's preferred approach) are proportionate in relation to perceived risks?

No further comments on the "preferred approach" in the consultation. (Please see the comments already provided above, in particular in the opening section of this response and in response to the question raised in Chapter 3.)

Question 2: Do you agree that our (Ofgem's) proposals would be positive for competition in the provision of energy networks and for energy supply markets?

The proposals are unlikely to have any measurable effect on the level of competition in the provision of energy networks and for energy supply markets, though this was not identified as a specific objective of the review of the ring fence conditions in the licences of NWOs.