

Hannah Nixon
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Dear Hannah,

Review of the Ring Fence Conditions in Network Operator Licences

Thank you for the opportunity to comment on the issues raised in the above review.

Of the three possible approaches set out NGN supports Ofgem's preferred incremental approach rather than the less or more intrusive approaches. We also agree that it is appropriate to update the ring fencing conditions to reflect the more complex financial and operating structures that are now prevalent amongst network licensees. In the case of NGN we consider that our existing high standards of corporate governance and risk management will enable us to comply with only very minor adjustments.

The one area where we have some reservations with your preferred approach is the requirement to have a majority of independent directors on the board of a network licensee. We agree with Ofgem's assessment of the value of independent directors and indeed the NGN board already contains independent directors. However, we don't believe there is a convincing rationale for requiring a majority and that the conflict of interest argument raised in the review is overstated given the statutory responsibilities of directors. Also, this proposal in our opinion strays too far into the detail of dictating how owners structure and manage their businesses.

Reference has been made to a similar obligation on water companies we understand the actual requirement is to have a minimum of three independent non executive directors not a majority.

Our responses to your specific questions are set out in the appendix to this letter. Please do not hesitate to contact myself or Haren Thillainathan if you wish to discuss any aspect of our response. Our response can be regarded as non-confidential.

Yours sincerely



Stephen Parker
Regulation and Commercial Director

APPENDIX

REVIEW OF THE “RING FENCE” CONDITIONS IN NETWORK OPERATOR LICENCES

CHAPTER: One

Question 1: 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?

Yes

CHAPTER: Two

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

The key risks identified the consultation document and CEPA's report appears to be:

1. lack of [sufficient] early warning of financial distress of network licensees
2. the potential narrowness of cash lock up
3. the lack of assurance over sufficient operational resources within a network licensee; and
4. insufficient sanction on behaviour of a licensee's directors in the midst of financial distress of the parent company

We agree that the first three risks above are legitimate concerns in light of the recent financial crisis in particular the speed and unexpected collapse of certain financial companies and as Ofgem have highlighted the increased gearing and complexity of corporate structures surrounding some network licensees. The fourth risk is conceivable but remains hypothetical albeit there are very few precedents or evidence to refer to the only obvious recent example is Wessex Water which remained intact despite the collapse of its parent Enron under similar ring fence conditions. Similarly going further back when the parent company of Midlands Electricity failed the ring fencing arrangements worked effectively. There does not seem to be any evidence that the directors of network operators acted in favour of the parent company to the detriment of the licensees and consumers. This is not surprising given the statutory responsibilities of directors.

CHAPTER: Three

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

Broadly yes, with the exception of the proposal for a required majority of independent directors as outlined in the covering letter.

However, Ofgem needs to take care with the detail of the proposals so that the regulatory controls only capture events which are in line with the policy objectives (i.e. directly linked to the potential financial distress of a company). Two examples of events that may be captured which are not directly related to evidence of financial distress in relation to the proposal on breach of financial covenants are:

- NGN's current financial covenants are calculated under UK GAAP, so to the extent that there is a convergence to IFRS covenants may need to be renegotiated with banks to fit with new accounting rules.
- Appendix 3 widens the potential breach from financial covenants to "banking or other financing covenants" which is unhelpful drafting as there are non-financial banking covenants such as delivery of accounts and other information requirements which could be captured.

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

Again we would agree overall we only question the proposals regarding a majority of independent directors which goes beyond “placing an emphasis” and seems based on the premise that company directors will fail to have regard for statutory responsibilities in the event the parent company experiences financial distress. We also consider this goes too far in dictating to owners how they manage and structure their businesses.

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

There will inevitably some costs arising from increased auditing, assurance and reporting but we do not believe these will be material.

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?

As mentioned in the letter we agree with the logic of having independent directors and suggest that there should be a minimum number as with the water companies. Ofgem would have to demonstrate the additional benefits of going beyond this to introduce a requirement for a majority.

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

Whilst we don’t have a particular problem with this proposal it does create an additional piece of bureaucracy that we don’t believe will achieve any benefit.

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

Wherever possible greater clarity in terms of wording definitions etc would be beneficial across licences given that the same principles are intended to apply, it would also make future reviews of ring fence policy across the energy sector more straightforward.

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

Yes

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

In this particular instance, probably not. The failure of a network operator will have serious consequences for the customers connected to that network irrespective of the size.

CHAPTER: Four

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 obvious alternatives are either a lighter touch self certification approach or a more intrusive reporting and monitoring regime.

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

Yes, ultimately as Ofgem appear to acknowledge such measures may be required in extreme circumstances to protect the interests of consumers connected to the network concerned.

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

Yes

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

No, we see that Ofgem have indicated clearly that it does not intend to pursue these options.

CHAPTER: Five

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

Yes with the possible exception on the proposals for a majority of independent directors as previously discussed in this response. Another issue for Ofgem to consider is whether the potential risks being addressed outweigh the impact of the preclusion of certain capital structures for example by the proposals to extend the scope and trigger of cash lock up arrangements.

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

We don't see anything in Ofgem's proposals that would distort or inhibit such competition.