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Dear Paul,

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

SSE and SGN welcome the opportunity to respond to Ofgem's consultation on a review of the 'ring fence' conditions. Our response to the questions set out in Ofgem's consultation is given in Appendix I.

We agree that it is prudent of Ofgem to review the network operators' ring fence licence conditions to ensure that they remain suitably robust. However, the recent period of economic downturn has tested these arrangements and the fact that none of the network companies have entered into financial distress in this time is evidence that the current conditions are fit for purpose.

The majority of the proposals suggested in Ofgem's preferred approach and, even more so, in the more intrusive approach, appear to be entirely disproportionate to the perceived risks. We would question the value that a number of these proposals add, particularly those that extend the current reporting requirements.

In particular, we strongly oppose Ofgem's proposal to require a majority of independent directors on the network companies' boards. Further, we would firmly oppose a requirement to have *any* number of independent directors and would reject any licence condition that sought to implement this. This proposal represents a fundamental and unnecessary shift in the operation and governance of network businesses and effectively removes the control that a network company has over the efficient operation of its business. This strong intervention is wholly unwarranted and is a disproportionate response to the perceived risks set out by

Ofgem, particularly as there are legal obligations under the Companies Act 2006 already in place to address such risks.

If you require any further information please do not hesitate to let me know.

Yours sincerely,

Rob McDonald
Director of Regulation

APPENDIX I

CHAPTER 1

- 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?**

We agree that it is prudent of Ofgem to review the network operators' ring fence licence conditions to ensure that they remain suitably robust. However, the fact that none of the network operators have entered into financial distress during this testing time is, we would argue, testament to the robustness of the conditions that are currently in place.

CHAPTER 2

- 1. Have we identified the key risks associated with any limitations of the existing ring fence conditions?**

We accept that Ofgem has outlined four potential key risks relating to the existing ring-fence conditions. We question, however, the likelihood of these risks playing out in practice and indeed the suggestion that the current licence conditions are insufficient to manage these perceived risks down to an acceptable level. To our knowledge, no network companies have been subject to the financial distress that we have seen in other markets in recent years.

CHAPTER 3

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

We believe that the 'enhancements' set out by Ofgem are a disproportionate response to the perceived risks in this area. In particular, the proposal to require a majority of independent directors on the network companies' boards is, in our view, a wholly unwarranted intervention, with significant consequences that may not have been fully considered. We discuss this further in our response to Q4. Our views on the other details of Ofgem's proposed approach are given in our response to Q3.

- 2. Do you think our preferred approach places the right emphasis on the responsibilities of NWO directors and managers?**

We believe the current legislation already does this.

- 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?**

As set out above, we believe the proposals put forward under Ofgem's preferred approach to be disproportionate to the perceived risks. Our strong views on the proposal to require a majority of independent directors on licensees' boards are discussed in our response to Q4. Our view on the remaining proposals in Ofgem's proposed approach are given below.

It is suggested that cash lock up triggers are widened to include: (i) any report of adverse circumstances under the availability of resources condition and; (ii) any breach of a financial covenant entered into by the licensee. The former appears not to be unreasonable; the latter appears to be an unnecessary proposal as we already have strong covenants in place with banks. Nevertheless, if this proposal is to be introduced, we believe careful consideration will need to be given to the legal drafting, with allowances provided for certain cases.

Financial covenants are again relevant when considering Ofgem's proposal to extend the restriction on granting security under the disposal of assets condition to cover current / future revenue streams and other debts held. Our existing strong covenants with banks render this proposal unnecessary. Further, this has the potential to damage the relationships we currently hold with the banks.

The proposal to introduce clear sanctions where resource adequacy statements are found to be inaccurate or out of date does not appear unreasonable. However, we do not support the proposal to extend our annual availability of resources certificate to include operational as well as financial resources. The term 'operational resources' is subjective and it is therefore not clear on what basis we would be expected to authorise such a certificate. For that reason we suggest that this would not add any real value. A 'living will' would be a substantive and onerous task to develop and maintain, and we would question the value it would add. An alternative and more proportionate solution could be to periodically undertake a similar review as was carried out in 2009 as part of the financial distress review.

We note Ofgem's suggestion that it would seek penalties against managers who had provided inaccurate or insufficient information to Ofgem. We believe this to be outwith Ofgem's legal powers and, in any case, an inappropriate undertaking from an economic regulator, particularly as there are already clear sanctions at director level.

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?

We strongly oppose the proposal to require *any* number of independent directors on the network companies' boards. We do not believe the perceived risks set out by Ofgem warrant any significant change to the current ring-fencing provisions, and Ofgem itself seems to recognise this:

"4.3 Retaining the existing provisions without change is a realistic option given that all NWOs and their parent groups came through the height of the recent financial crisis largely unscathed."

Placing restrictions on the makeup of the NWOs' boards amounts to strong intervention when practice shows that little or no intervention is actually needed.

Importantly, all directors are subject to the same legal requirements. Our current board members are subject to the same ring fence conditions in the licence and detailed duties set out in the Companies Act 2006 as any independent board member would be, both now and under Ofgem's preferred approach. Given that the makeup of the board does not change the directors' duties, it is difficult to see that there would be any real benefit in mandating a board structure that incorporated independent directors, let alone a majority of independent directors.

Moreover, to our knowledge, no licensed network operator is independently quoted. The requirement to have a majority of independent board members has historically applied at group level. We see no sound justification for extending this to licensee level. Further, we would argue that the existence of a majority of independent directors at group level ensures that appropriate independent overview is already given to our distribution businesses. Ofgem's proposal therefore involves micro-management of network operators. We firmly believe that a requirement for so-called independent directors would

undermine our ability to effectively and efficiently run the business. SSE has consistently been at the frontier in efficiency in successive price control reviews. This performance has been achieved by SSE staff and we do not believe it would be replicated by a random collection of 'independent' directors.

Driving mandated board structures of any sort would also drive the NWOs' boards to conform to a particular type, potentially reducing board diversity and unique traits that can give competitive edge and benchmarking opportunities. Similarly, by reducing the number of board directors appointed from within the licensee's group structure, there is a risk that operating efficiency could suffer. Independent board directors would not be expected to have the same knowledge of the business or experience of operations.

There is also the issue of sourcing and appointing board directors and the availability and suitability of independent directors. Independent directors might, at least initially, not have the same knowledge of the business or experience of operations as our current directors. In a mandated board structure, there is therefore a risk that inability to source a suitable person would result in the appointment of a board director without the necessary business and operational knowledge, in order to avoid breach of licence.

Ofgem drew parallels with the banking crisis. Many of the banks who are now technically bust had a majority of independent directors. Although we are not suggesting that this is wrong, it does point to the fact that a majority of independent directors would not solve all of the problems perceived by Ofgem, and that a wider debate on corporate governance is required.

Markets are sensitive to the stability of boards, and there is a significant concern that radical changes to the board structure could affect investment at group level.

Further, in accordance with the business separation requirements of our licences, we ensure that directors of our network companies do not have cross directorships with other group companies such as generation and supply. All board meetings are properly held, minuted and reviewed by the compliance officer.

We therefore firmly oppose any proposal to mandate any number of independent board directors and would reject any licence condition that sought to implement this. It is not Ofgem's job to second guess the best management structure for our organisation. If the obligation to have a new management team is imposed on us, and endorsed by the Competition Commission and the courts, we may need to consider re-opening the distribution price control as a new management team could have a different view on what is suitable.

Notwithstanding this position, and the fact that we believe the current arrangements are demonstrably fit for purpose, we believe there are more proportionate steps that could be taken to give increased comfort that existing board directors are fully aware of their duties. For example, we already carry out regular briefings to directors of their duties and legal requirements; there could be merit in formalising this arrangement.

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

We do not believe that this would add any real value. As a consequence, before this obligation is extended, we would ask Ofgem to demonstrate what this information would be used for and how it would improve regulatory supervision. We would make the same

point in relation to other proposed extensions to the reporting obligations such as the 'living will'.

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

We do not believe this is necessary as it adds no real benefit to the current arrangements. However, if the ring fence conditions were to be consolidated, it would seem more sensible for this to coincide with, for example, wider changes to the licence as a result of price control reviews.

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

We firmly agree that changes should not apply retrospectively.

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

We see no reason for any type of licensee to be treated differently. However, if a particular licensee is deemed 'high risk', it may be appropriate for Ofgem to have bilateral discussions with that licensee about what further means may be required.

CHAPTER 4

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 consider that the less intrusive approach could provide benefits. We would strongly oppose the more intrusive option given the weakness of the case for change. Further, in our view, this option would require a significant amount of work and not provide any additional protection to customers.

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?

We agree that higher prices as a result of an individual NWO ending up in a position of financial distress are unlikely to have significant impact overall.

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

Although the more intrusive approach clearly includes more stringent requirements, we believe that when evaluated against Ofgem's preferred approach, generally it does not add any additional control to the areas that Ofgem has flagged as concerns. In particular we note Ofgem's reference to financial resource indemnity under the more intrusive option. We agree that this would be an inefficient means to address a very low risk issue and as such we would firmly oppose any such proposal.

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

Given that we consider that there is no case for changing the current ring fence conditions, we believe the 'more stringent' proposals are wholly disproportionate to the perceived risk and therefore inappropriate.

Moreover, we agree that this would result in increased costs to consumers without any sound justification.

CHAPTER 5

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

The recent period of economic downturn has tested the current arrangements and is evidence that they are fit for purpose. None of the network companies have faced the sort of financial difficulties that Ofgem is now trying to introduce steps to avoid, despite being exposed to the deepest recession since the Great Depression. On this basis, we believe Ofgem should retain the existing provisions.

Notwithstanding this view, if Ofgem is intent on imposing revised requirements, we believe these must be proportionate to the size of the risk. To this end, we firmly disagree with any proposal to mandate board structures. This is a significant and disproportionate change which is not warranted by recent events.

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

We see no reason why Ofgem's proposals would be positive for competition. Indeed, in our response to Q4, we have set out a view that competition could be adversely impacted through Ofgem's proposal to drive board structures to conform to a specific type.