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Dear Hannah,

Impact Assessment and Consultation on the review of 'Ring Fence' conditions in Network Operator Licences

The Wales & West Utilities Ltd (WWU) response to your consultation on the review of the 'Ring Fence' conditions in Network Operator Licences is detailed below.

WWU is a licensed Gas Distribution Network (GDN) providing Gas Transportation services for all major shippers in the UK. We cover $\frac{1}{6}$ th of the UK land mass and transport gas to over 2.4 million supply points. WWU is one of only two Gas Transporter Licence Operators that focus solely on Gas Distribution in the UK.

Executive Summary

WWU support this review and recognise the importance of stress testing the existing ring fence conditions along with implementation of incremental changes where appropriate. We believe that any changes to the existing ring fence conditions should take into consideration that despite an unprecedented period of financial instability during the past 12 months, Network Operators (NWOs) have addressed the challenges faced and have remained relatively unscathed.

Our specific comments on the preferred approach as outlined in chapter 3 of the consultation and our answers to the specific questions raised are included in the appendix to this letter.

The consultation also discussed the relative merits of a less or more intrusive approach. It is our view that a less intrusive approach, including the potential removal of the credit rating provision in its entirety, would be detrimental. Investors place significant reliance on the regulatory obligations of NWOs. To weaken the existing ring fence provisions from their current level and in comparison to those imposed by Ofwat, would in our opinion be detrimental to the ability of a NWO to raise long term financing and would be likely to result in a higher overall cost of capital.

A more intrusive approach would significantly increase the administrative burden of compliance on the NWO. This in turn would increase the level of resources required by Ofgem in facilitating a more detailed regulatory regime, the cost of which would ultimately be borne by consumers.

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We do not consider that a more intrusive approach would be appropriate, particularly given the past financial stability of NWO's under the existing ring fence regime.

Yours sincerely

A handwritten signature in black ink, appearing to read "S Edwards", with a long horizontal flourish extending to the right.

Steve Edwards
Head of Commercial and Regulation
Wales & West Utilities

APPENDIX – Answers to specific questions raised

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 consider?

WWU believe that the relevant objectives have been identified in this review.

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

WWU believe that the review has identified the key risks associated with the limitations of the existing ring fence conditions.

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?

The proposed enhancements to the ring-fence regime are broadly consistent with meeting the specified objectives going forward. However, specific comments on the proposed changes are discussed in questions 3.3 and 3.4 below.

In WWU's view the requirement for change should take into consideration that despite an unprecedented period of financial instability in the past 12 months, NWO's have addressed the challenges faced and remained relatively unscathed. We do however recognise that it is important for the current arrangements to be stress tested and incremental changes implemented where appropriate

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

In general terms, the primary obligation for financial stability should always remain with managers and directors of the NWO's. We feel the role of the regulator in the normal course of events should be to monitor compliance with the regulatory regime. We believe that the regulator should only be directly involved in a notified 'distress' situation.

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

References are to specific proposals as detailed on P14 of the consultation

“Strengthening of the cash lock up provision under the restriction of indebtedness by increasing the likelihood that the mechanism is triggered at a sufficiently early stage. This would be done by widening the trigger for lock up.”

The specific proposal is to introduce two additional triggers alongside the credit rating trigger:

- (i) Any report of adverse circumstances under the availability of resources condition
- (ii) Any breach of a financial covenant entered into by the licensee or any renegotiation of the covenant for the purposes of avoiding a breach

An adverse comment under (i) would mean that in the opinion of the directors, the licensee will not have sufficient financial resources and financial facilities available to itself to enable the

licensee to carry on its license obligations for a period of 12 months from the date of the certificate. In such a circumstance it would be appropriate for a cash lock-up. However, the circumstances that led to this statement being made would be potentially capable of remedy at any time (e.g. successful completion of a refinancing). Therefore we feel it would be essential that an appropriate method existed for the cash lock-up to be removed. We think it would be unduly onerous for a NWO to be forced to wait a further 12 months for the next scheduled A37 statement to be made.

In our opinion the proposal as described under (ii) above is currently too wide. A consideration as to whether a cash lock-up would be appropriate would ideally be considered in conjunction with the nature of the specific covenant and/or the nature of the breach/renegotiation.

Rating Agencies will typically rate the financial structure of a NWO by consideration of its covenants, particularly including its level of gearing and interest cover ratios. The potential therefore arises for a NWO to renegotiate the covenants with its lenders which could potentially result in a revision of the rating by one grade say from A- to BBB+. Such a renegotiation should be of no consequence to the regulator as the resulting comfortable investment grade still indicates that the NWO remains on a stable financial platform. We believe therefore that any proposal under (ii) should only be considered in the context of specific covenant renegotiation which could impact on the ability of a NWO to retain its investment grade rating.

A cash lock-up due to a breach of banking covenants would in most cases be appropriate and the lock-up would be enforced by the financing structure. However, once a NWO has taken the appropriate steps to remedy a breach to the satisfaction of its lenders, then the provision of appropriate evidence of this fact to Ofgem should be sufficient in order for the cash-lock up to be removed.

Extension of the annual availability of resources certificate submitted to the authority to cover operational as well as financial resources.

In WWU's opinion, the extension of the statement should have limited impact on a NWO as the scope of the license condition already covers operational as well as financial resources. It is entirely appropriate that any matters, both operational and financial, that would impact the ability of a NWO to fulfil its license obligations in the forthcoming year should be within the scope of the availability of resources statement. However, the scope of the accompanying report required from the external auditors should be limited to financial resources, as an extension of the audit review would be likely to incur significant additional cost. Further to this, the external auditors would be unlikely to have the requisite skills and experience to comment on the adequacy of operational resources.

We feel that further guidance would be required as to the form and maintenance of the 'living will' as discussed in section 3.15. As discussed, these records should already exist as part of good corporate governance. We would require further clarity as to the envisaged scope to assess the level of administrative burden and hence whether the proposal is appropriate

3.4 Do you agree that NWO's 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 are not aware that the lack of a formal requirement for a NWO to have independent directors has historically caused any problems and therefore our view is that the board

composition should remain at the discretion of the individual licensee. It is recognised that a minimum level of independent directors is viewed positively by rating agencies and therefore we feel any change to the current requirements should be to introduce a minimum level of independent directors similar to the current requirements of Ofwat. In our opinion, extending this requirement to being a majority would cause both a disproportionate cost and administration burden on a NWO. It would not be unusual for a NWO with diverse ownership to have up to 6 shareholder appointed directors and therefore the requirement for a majority of independent directors would lead to an excessive number of board members, with a resulting cost which would ultimately be borne by the gas consumer. Additionally, a board of excessive size could have a negative impact on efficient decision making and the ability of such a board to act promptly and effectively.

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

We feel that the requirement to resubmit the requisite deeds to Ofgem would seem unnecessary where there has been no change to the parties.

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

WWU would assume that any changes to the ring fence conditions will be consolidated within the license.

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

We agree that making any changes retroactively would be extremely difficult as NWO's will have financing structures in place which reflect the requirements that were in existence at the time that they were incepted.

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

We believe there is a strong argument that any changes to the ring fence conditions should be consistently applied across all licensees. This will provide clarity of the criteria for NWO's and investors.

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?

WWU agree that this broadly summarises the other options which could be considered.

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

We believe that a less intrusive approach would not be welcomed by Rating Agencies and/or potential investors in NWO's. Significant reliance is placed and comfort obtained from the current ring-fence conditions and the regulatory certainty is a positive to investors looking to make a long term investment. Although there might be a reduction in administrative burden it is our view that this would be outweighed by increased costs. Finance providers place significant

reliance on the ring fence conditions and hence we believe any dilution/removal could result in a higher overall cost of capital.

The suggestion of removing the credit rating provision in its entirety would not be supported by WWU. Investors in a NWO place significant reliance on the regulatory requirement for an investment grade credit rating to be maintained. A dilution of the requirement would weaken investor confidence and therefore increase the overall costs of debt for a NWO.

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

In WWU's opinion, there is little argument for a more intrusive approach. Bearing in mind that despite an unprecedented period of financial instability in the past 12 months, NWO's addressed the challenges faced and remained relatively unscathed. The current level and detail of regulatory submissions requires a significant amount of internal resource to monitor compliance with existing obligations. Additionally, the requirement to maintain an investment grade rating (which for most capital markets issuers would be two ratings), creates an additional stringent level of compliance and monitoring.

More detailed monitoring would create a significant additional burden on both the regulator and the NWO which would be likely to outweigh any potential benefit gained as the costs of compliance would ultimately be borne by the gas consumer.

Further to this, we would not welcome specific conditions such as those outlined in 4.24 and 4.26. Whilst specific conditions are relevant to the overall financial stability of a NWO they should not be considered in isolation. The financial stability of a NWO is a product of many factors and should be subject to overall assessment by the managers and directors of those companies as well as other stakeholders.

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

We feel that the proposed enhancements to the ring-fence regime are broadly consistent with meeting the specified objectives going forward. However, specific comments on the proposed changes are discussed in our responses to the questions in Section 3 above.

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

WWU agree that Ofgem's proposals would be positive for competition in the provision of energy networks and for energy supply markets.