

Proposed Modifications to the 'Ring Fence' Conditions in Network Operator Licences

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Target audience: Network companies and their owners, finance providers, energy suppliers, customers and their representatives and other interested parties.

Overview:

Energy networks form a vital part of our national infrastructure. Network operators are subject to licence conditions which protect the assets and resources funded by consumers and ensure that sufficient resources are available to the network business in all circumstances. These conditions are known collectively as the regulatory ring fence.

In March 2010 we published an impact assessment and initial consultation on possible changes to the ring fence to improve its effectiveness. Having considered the responses, we are ready to set out updated proposals.

We are now seeking the views of stakeholders on our detailed proposals and their applicability to different types of network operator. This will help us to decide on the changes we should seek to implement during 2011.

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Context

Our principal objective is to protect the interests of existing and future consumers. The transmission and distribution networks which carry gas and electricity to domestic and commercial users are a vital part of our national infrastructure. It is in consumers' interests that we ensure that the companies which own and operate these networks always have the financial and operational resources necessary to meet their obligations under legislation and licence requirements. This does not mean we are seeking to eliminate the risk that financial distress could affect a network operator; this would neither be possible nor commercially desirable. Primary responsibility for the financial well being of each network operator lies with its managers and owners.

Consumers are to some extent insulated from financial problems which might affect a network operator because:

- their contractual relationships are generally with suppliers who deal with network companies on their behalf,
- they are unlikely to be creditors of a network company and so would not be at risk of losing money if a network operator became insolvent, and
- there are contingency arrangements in place to ensure continuity of energy supplies.

However, there are good reasons for having measures to reduce the risk of a network operator experiencing financial or operational distress or to mitigate the impact if it does. For example:

- if price controlled revenues were allowed to rise to address a financial distress episode the effect would flow through to higher bills for consumers,
- if finance providers incurred losses because of a restructuring or insolvency event the cost of capital for network operators could increase which could lead to increased charges for consumers,
- if there was a shortfall in funds needed to meet the costs of an administration process this would ultimately be borne by consumers, and
- if a network operator could not access sufficient financial or operational resources the development of its network and customer service levels could suffer in the short or longer term.

Ring fence conditions were added to network operator licences during the 1990s to support corporate governance arrangements. They have worked well, and none of the network operators has to date been seriously affected by the 'credit crunch' or the recent financial downturn. Nevertheless we need to update and improve the ring fence conditions to reflect changing risks and industry structures, so that it continues to be effective in the future. In drafting our updated proposals we have taken account of responses to our initial consultation (published in March 2010) and subsequent feedback. We will carefully consider all responses to this consultation before reaching any decisions. If appropriate we will arrange further industry meetings to refine the drafting of licence condition modifications before issuing statutory notices, subject to the consultation process.

Associated documents

1. Separate Appendices document (Ref 42a/11)
 - a. [Review of the Ring Fence Conditions in Network Operator Licences – Impact Assessment and Consultation \(3 March 2010\) \(Ref 30/10\)](#)
http://www.ofgem.gov.uk/Networks/Policy/Documents1/IA_Ring_Fence_Review_3%20Mar%2010_final.pdf
 - b. [Ofgem web page with CEPA report and responses to impact assessment and consultation](#)
<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=268&refer=Networks/Policy>
 - c. [Standard Conditions of the Electricity Transmission Licence](#)
<http://epr.ofgem.gov.uk/index.php?pk=folder380751>
 - d. [Standard Conditions of the Electricity Distribution Licence](#)
<http://epr.ofgem.gov.uk/index.php?pk=folder499235>
 - e. [Standard Conditions of the Gas Transporter licence](#)
<http://epr.ofgem.gov.uk/index.php?pk=folder414978>
 - f. [Standard Special Conditions of the Gas Transporter Licence](#)
<http://epr.ofgem.gov.uk/index.php?pk=doc510952>
 - g. [Arrangements for responding in the event that a network company experiences deteriorating financial health – position paper](#)
<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=245&refer=Networks/Policy>
 - h. [Arrangements for responding in the event that an energy network company experiences deteriorating financial health: Consultation Document](#)
<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=248&refer=NetworkN/Policy>
 - i. [Arrangements for responding in the event that an energy network company experiences deteriorating financial health](#)
<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=259&refer=Networks/Policy>

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Appendices 10 to 14 appear in the separate Appendices document (Ref 42a/11) – see appendices table on page 45.

Summary

Energy network operator companies (NWOs) own and operate the essential infrastructure which transports gas and electricity from producers and generators to domestic and commercial consumers. The network businesses are natural monopolies and are subject to price controls. It is important for consumers that our regulation of the networks ensures operational continuity and promotes financial stability, although primary responsibility for these issues and for good corporate governance lies with the owners and boards of network businesses.

Network operators are covered by a special administration process which would ensure continued network operation in the unlikely event of insolvency¹. During 2009, in light of the banking crisis, we decided that we should review our procedures for managing the risk of financial distress affecting an NWO, even though we consider this risk to be relatively low. As part of this process we identified some scope for improvements to the ring fence conditions, which were introduced in the mid 1990s. The improvements relate to an increased focus on operational resourcing, better early warning mechanisms and the introduction of extra measures to mitigate the severity of financial distress should it arise. In March 2010 we published an initial consultation and impact assessment on our preferred approach to update and improve the ring fence. Our current proposals, summarised below, reflect the consultation responses we have received to date.

Proposed changes to existing ring fence conditions

(i). Restrictions on disposing of or granting security over network assets

This condition essentially prevents NWOs from disposing of network assets without consent from the Authority². The restrictions also apply to granting security over these assets or giving up operational control of them. We are proposing that the restriction on granting security should be extended to cover receivables on the balance sheet of the network business meaning that this class of assets (particularly income from use of system charges) would definitely be unencumbered in a financial distress scenario.

(ii). The requirement to have all necessary resources available to run the network business

This condition requires an NWO to ensure that it always has available the financial and operational resources needed to carry on its network businesses. It requires the company's board to submit an annual certificate confirming that the NWO will have the financial resources it needs for the following 12 months. We are proposing that this certificate should also cover business and operational resources and compliance with key licence conditions. This would impose a requirement for the board to consider the adequacy of all resources required for the business on a forward looking basis, including those provided under service contracts. We are also proposing that NWOs should have to maintain an 'intervention plan' containing key financial and operational information so that, in any contingency, a management team would have ready access to crucial business information.

¹ The special administration process is set out in Chapter 3 of Part 3 of the Energy Act 2004.

² The Gas and Electricity Markets Authority – Ofgem is the office of the Authority

(iii). The requirement to obtain undertakings from ultimate controllers of network companies regarding licence compliance

This condition requires the NWO to obtain an enforceable undertaking from each of its ultimate controllers saying that they will not do anything which would cause the licensee to be in breach of its licence. We are proposing that the NWO should, on an annual basis, provide us with an updated schedule of its ultimate controllers and write to each of them reminding them of their responsibilities. This should ensure that the terms of the undertaking(s) remain at the forefront of management attention and prompt the NWO to obtain new undertakings when required.

(iv). Restrictions on indebtedness and the types of payments and transfers that can be made to affiliates of the network company

This condition specifies that the NWO can only take on debts for the purpose of the network business and on normal commercial terms. It also restricts the types of payments and transfers that an NWO can make to related parties and provides for these restrictions to be tightened (a 'cash lock up') if the NWO loses its investment grade credit rating. We are proposing that there should be two additional trigger categories for the cash lock up relating to any adverse availability of resources certification and any material breach of a financial covenant by the NWO. The additional triggers should improve the likelihood of the cash lock up operating in a timely and effective manner.

We are not proposing any changes to the other two ring fence conditions which cover the requirement to hold an investment grade credit rating and restrictions on non-network business activity.

Proposed new ring fence condition requiring two sufficiently independent directors

We are also proposing that there should be a new ring fence condition requiring NWOs to have two sufficiently independent directors on their boards to mitigate the risk that executive directors with other group roles could become conflicted at times of crisis and to contribute to good governance at NWO level.

An earlier reference (in our March 2010 initial consultation) to a requirement for a majority of independent directors proved to be contentious and we have significantly developed our proposals to address the concerns which have been raised in formal responses and discussions. We have reviewed two suggested alternatives which respectively refer to a requirement for an auditor's report on pre-dividend certificates and an emphasis on corporate governance regimes at group level. We view these proposals as having some merits but our present view is that:

- a pre-dividend audit report would only address one particular risk and would be characteristic of a more interventional regulatory approach which is not favoured,
- good governance at group level, whilst desirable, cannot provide the sufficiently independent voice at NWO board level which we consider is necessary and would be especially valuable at times of contingency.

We will carefully consider responses to this consultation received by the deadline on 30 June 2011 before reaching a decision on the licence modifications to be made. We hope to be in a position to publish our decisions by September 2011.

1. Introduction and objectives

Question box

Question 1: Have we identified the risks and concerns which are important to you if you are:

- a network user (consumer, generator, shipper or supplier)?
- a finance provider, network owner or other stakeholder?
- a network operator?

Question 2: Do you think that any of our proposals will require deferred start dates to allow NWOs to make preparations for compliance?

Introduction

1.1. Our principal objective is to protect the interests of existing and future consumers. We do this by promoting effective competition, wherever appropriate, and through regulation where necessary. One of the factors we are required by legislation to take into account in carrying out our responsibilities is the need for network operators to be able to finance their regulated activities. Energy network companies are natural monopolies. We set price controls to ensure that efficient companies can earn a fair return after efficient investment and operating costs whilst limiting the amounts that customers can be charged through their energy bills.

1.2. Throughout this document we use the term 'network operator' (or NWO) to refer to a company which holds a gas transporter, electricity transmission or electricity distribution licence³. Where appropriate we refer to the sub-categories of network operator as follows:

Gas networks

- the gas transmission network operator,
- gas distribution network operators ('GDN's),
- independent gas transporters ('IGT's),

Electricity networks

- electricity transmission network operators,
- offshore transmission network operators ('OFTOs'),
- electricity distribution network operators ('DNO's), and
- independent distribution network operators ('IDNO's).

³ National Grid Gas plc uniquely holds two gas transporter licences. One covers its operation of the GB-wide gas transmission network and the other covers its operation of four of the eight regional gas distribution networks.

1.3. This review does not cover gas or electricity interconnector licensees. In addition, it should be noted that some independent gas transporters who operate limited scope networks (for example a single pipeline between a gas storage facility and a GDN network) have the majority of ring fence conditions 'switched off' in their licences. We do not propose that any additional conditions should be made active for these licensees but, if the conditions were switched on in future as a result of changed circumstances, the applicable conditions would include any modifications under this review. Further background information on this review of the ring fence conditions and our proposals is given in Appendix 2.

1.4. The ring fence conditions in NWO licences form an important part of our regulatory approach to managing the risk that financial distress could affect network operators and have these broad objectives:

- preventing the onset of financial distress by imposing a range of regulatory requirements to back up the corporate governance arrangements put in place by the managers and owners of NWOs,
- providing warning signals when symptoms of financial distress appear or potential threats are identified,
- mitigating the severity and impact of financial distress factors should they arise and reducing any 'chain reaction' of adverse financial events, and
- facilitating price control re-opener measures or the special administration process in extreme circumstances.

1.5. During 2009, in light of the global credit crunch and ensuing economic downturn, we reviewed and updated our procedures for responding to a situation where one or more network operators was experiencing financial distress. During this work we identified some areas where the ring fence regime could be improved, centring on an increased focus on operational resourcing, better early warning mechanisms and additional features to mitigate the severity of financial distress should it arise.

1.6. In March 2010 we published an initial impact assessment and consultation on possible changes to the ring fence conditions. We outlined three different ways forward which we had identified including the possibility of much more or much less interventionary regulatory requirements. However, having identified drawbacks with the latter two options we explained that our preferred approach was to improve and update the existing ring fence conditions with focussed modifications and to introduce a new ring fence condition relating to independent directors.

1.7. After consideration of the responses we received to the March 2010 consultation, the Authority decided that we should develop the updated proposals included in this document and summarised in the table below.

Table 1.1 – Summary of our proposals

Condition	Proposed change
Disposal of relevant assets	<ul style="list-style-type: none"> • Restriction on granting security extended to cover receivables on the NWO's balance sheet⁴
Availability of resources	<ul style="list-style-type: none"> • Annual certificate to cover operational resources and key licence condition compliance as well as availability of financial resources • NWO to maintain an intervention plan containing essential financial and operational information
Undertaking from ultimate controller	<ul style="list-style-type: none"> • NWO to provide an updated schedule of ultimate controllers each year • NWO to write to ultimate controllers each year reminding them of their responsibilities
Indebtedness	<ul style="list-style-type: none"> • Two additional cash lock up triggers relating to <ul style="list-style-type: none"> ○ adverse availability of resources certification ○ material breach of a financial covenant
[New condition]	<ul style="list-style-type: none"> • Requirement for two sufficiently independent directors on the board of the NWO⁵
Credit rating	<ul style="list-style-type: none"> • No change to this condition
Restriction of activity	<ul style="list-style-type: none"> • No change to this condition

1.8. The proposed modifications summarised in the table above are described in more detail in chapter 3 and (in relation to sufficiently independent directors) chapter 4 of this document. We have also provided a round up of responses to earlier consultations in chapter 2 and a summary of our views on the impacts of our proposals in chapter 5. Appendix 4 contains our comments on specific points raised by respondents in relation to a possible requirement for independent directors.

⁴ Would not apply to OFTOs

⁵ Would not apply to OFTOs, IGTs or IDNOs

Objectives and reasons for our review of the ring fence

1.9. The ring fence arrangements have worked well since they were put in place during the 1990s. Nonetheless, we consider it necessary to update and enhance the regime to reflect developments in ownership and operational structures and to manage the risks which have become apparent from the recent liquidity crisis and economic downturn. The relevant risks to which corporate groups may be exposed include:

- Highly geared structures when there could be abrupt changes to the availability of debt and equity finance.
- Sudden increases in the cost of debt finance.
- Misunderstanding of risks associated with new or unfamiliar financial products which may be included in treasury operations and the risk of default thereon.
- Failure of senior managers and boards to challenge trading or financing initiatives which they do not fully comprehend.
- Share price falls leading to covenant breaches.

1.10. We are aware that there are significant differences between the energy sector and the banking sector, which was particularly affected by the credit crunch. We also appreciate that the likelihood of an NWO experiencing financial distress because of problems at corporate group level is relatively small. Nonetheless, the risk is real and present, and the impact of such an episode on consumers could be very significant. Our proposals are intended to ensure that our approach for managing this risk is fit for purpose, but they do not mean that we are becoming more risk-averse as a regulator.

1.11. Some NWOs have suggested that Ofgem already has the powers necessary to intervene after any onset of financial distress and should not seek to implement measures which impinge on management of businesses in the meantime. We agree that in some respects, less regulation can constitute better regulation, but we would be abrogating our duties if we did not ensure that safeguards and preventative measures in the regulatory regime are kept up to date and effective. We also consider that improved ring fence conditions are fully consistent with the view that responsibility for good governance and regulatory compliance lies with the owners and managers of network businesses. In particular, the augmented conditions should address concerns that the existing ring fence conditions do not focus sufficiently on operational (as opposed to financial) aspects of the NWO businesses and that they might not provide early enough warning of financial or operational distress.

1.12. In formulating our proposals we have sought to:

- reflect the Authority's view that it did not consider it appropriate to introduce either a much less or much more intrusive regulatory approach than the current ring fence arrangements represent,
- minimise interference with the direction or management of network businesses and legitimate influence from business owners,
- acknowledge that diversity in ownership and corporate structures can be beneficial for consumers,
- minimise additional regulatory burden,

- arrive at a focussed package of sustainable enhancements and avoid a sense of ‘ring fence creep’,
- take account of the responses and feedback we have received to date, and
- propose updates to the ring fence which will provide appropriate certainty and stability going forward.

1.13. We have also tried to produce draft conditions in which the requirements are as clear as possible, to avoid unnecessary effort by NWOs in adhering to them. However, we would especially welcome comments on aspects of drafting which respondents feel could be improved or clarified.

1.14. Whilst the modified conditions would continue to include a number of clauses allowing the Authority to consent to variations in compliance requirements we consider that these should continue only to be used in exceptional circumstances with any ‘tailoring’ of licence requirements achieved at the drafting stage. None of the proposed measures (see Summary above and chapters 3 and 4) would have retrospective effect.

1.15. Our proposed enhancements to the ring fence consist of additional stipulations under four of the existing ring fence conditions as well as one additional condition relating to sufficiently independent directors (see chapter 4). We do not consider that any of the existing requirements could safely be omitted to ‘compensate’ for the new requirements, although we will continue to look for opportunities to remove unnecessary or redundant provisions across the gamut of networks regulation. We have also been conscious of the need to guard against unintended consequences of licence modifications. We believe that our updated proposals pass this test but we will carefully consider the responses we receive to this consultation in that respect.

1.16. We recognise that our proposals could result in some costs, both financial and in terms of compliance effort. However, we consider that the benefits which the modifications will bring considerably outweigh those relatively modest costs⁶. We have also indicated that NWOs will be allowed to recover efficiently incurred incremental costs of compliance through their price controls. We have not to date tried to quantify the costs of our proposals but regulation and group board costs presently represent about 5% of an NWO’s indirect business costs. We do not believe that our proposals would make a material difference to this figure. We would, however, be interested in respondents’ views on the likely financial costs of the proposals set out in this document.

1.17. The main factors affecting NWOs’ access to and cost of finance are likely to relate to price control parameters; even so, we consider that our proposals will have a broadly beneficial effect in that regard. Finance providers have indicated to us that they attach considerable importance to the ring fence regime. We recognise that smaller independent network operators are subject to a relative price control and are more likely to be reliant upon bank lending facilities.

⁶ Section 7B of the gas Act 1986 and Section 7(1) of the Electricity Act 1989 say that NWO licences may contain conditions which are requisite or expedient with regard to certain objectives of the secretary of State for Energy and Climate Change and the Authority.

Variations between network operator types

1.18. With some exceptions and variations, the existing ring fence conditions apply to all types of network operator and our proposed changes would continue that principle, but some of the new requirements would not apply to OFTOs, IGTs or IDNOs, reflecting particular characteristics of those businesses.

1.19. We have taken into account the fact that when this consultation is published the first batch of OFTO licenses will only just have been granted (although the standard conditions of the OFTO licence have been published). We did consider whether it might be better to consider possible changes to the ring fence conditions in OFTO licences as part of the licence granting process. However, we feel it is more appropriate to consider possible changes to the ring fence for OFTOs together with all other types of network operator so that the relevant stakeholders can consider our proposals in that wider context and participate fully in the consultation process.

Implementation of particular provisions

1.20. We have detailed our proposed changes to all of the licence conditions referred to in the separate appendices document which accompanies this consultation (associated document 1). Our drafting of possible changes reflects the consultation which has taken place to date including an early circulation of specimen modifications to network operators in October 2010.

1.21. The deadline for responses to this consultation is 30 June 2011. After careful consideration of responses we will decide on the licence modifications which we consider should be implemented. After making any appropriate changes to the drafting of modifications we expect to give formal notice of intended licence modifications⁷. We expect that it will be possible to issue the required notices by September 2011. The statutory notices provide a further opportunity for representations or objections to be made. Subject to this process, we hope that the relevant modifications to the ring fence conditions would be in effect by November 2011.

1.22. We would be particularly interested in respondents' views on whether particular requirements might require preparation periods meaning that their effective start dates should be deferred in the drafting of the relevant conditions. Such drafting might take a form such as "On and from DD/MM 20XX, the licensee must.....".

⁷ The legislative provisions relating to the modification of standard conditions of network licences are expected to be amended by regulations made by the Secretary of State approved by Parliament during 2011 – see further information at paragraph 6.4 in the Next Steps chapter

2. Summary of responses to date

Responses to our impact assessment and initial consultation

2.1. We received a good number of responses to our initial consultation on the ring fence review (associated document a), although nearly all came from NWOs and their owners. We would be interested to receive responses to our current consultation from all stakeholders, including consumer groups, finance providers, other regulators and government departments.

Views set out in our initial consultation

2.2. In March 2010 we published an initial impact assessment and consultation on possible changes to the ring fence conditions in NWO licences (associated document a). In that document we identified some possible weaknesses in the existing ring fence conditions relating to a lack of focus on operational risks and early warning mechanisms and over-reliance on the credit rating process in respect of cash lock up provisions. We said that our proposed approach was to introduce focussed enhancements to the ring fence conditions in NWO licences but we also set out two broad alternative approaches which we had identified but which we did not consider were the right way forward:

- (i). A less intrusive approach, removing some ring fence restrictions and placing greater reliance on resource certification by directors and the 'backstop' measures of price control re-opening or special administration.
- (ii). A more intrusive approach incorporating more restrictions, prescriptive measures and reporting requirements.

2.3. Our preferred approach in March 2010 suggested that the ring fence be developed by:

- extending the restriction on granting security over assets to cover debtor assets on the NWO's balance sheet,
- extending the annual availability of resources certification requirement to cover operational as well as financial resources,
- outlining clear sanctions where resource availability certificates proved to be inaccurate,
- requiring the NWO to produce and maintain a 'living will' record of key financial and contractual arrangements,
- increasing the number of triggers for the cash lock up under the restriction of indebtedness condition,
- requiring NWOs to have a majority of independent directors on their boards.

General views

2.4. Most respondents felt we had identified the right objectives for our review of the ring fence, although fewer agreed that the existing provisions had significant weaknesses. The existing conditions were generally still considered to be fit for the purpose of managing known risks. Consequently there was a mix of views about whether our early proposals would achieve the stated objectives and about the costs and benefits involved. There were also some concerns about the risk of unintended consequences. However, some respondents also pointed out that the prospect of corporate groups 'gearing up' to finance expanding capital programmes and the change from the RPI-X format of price controls to RIIO⁸ could add risk to the picture.

2.5. In general, NWO respondents were against increasing the level of regulatory burden and felt that modifications should not have retroactive effect. NWOs also considered the examples of more interventionist measures which were exposed for comment to be disproportionate. Some respondents considered that we had placed too much emphasis on the possibility of financial distress or special administration affecting a network company and that problems which had emerged in the banking sector were of limited relevance to NWOs because incentives for managers to take undue risks are not present.

2.6. There were diverging views on the emphasis we had placed on the role of NWO directors and managers, considering that companies legislation in particular already imposes a robust conduct regime. However, nearly all respondents were against our proposed requirement for a majority of independent directors on NWO boards.

2.7. There was a general feeling that the drafting of any licence modifications should promote consistency between licence types and the use of plain language as far as possible, but recognition that this would be limited by historical differences in licence formats. Most agreed that substantive updates to the wording and layout of conditions should be left until full reviews of those licences take place. One respondent felt that any modification of ring fence conditions for each type of NWO should be deferred until their next price control review. Some respondents felt there should be a presumption against varying any ring fence requirements between different types of NWO. Conversely, there was one suggestion that enhanced requirements could be applied to specific NWOs where elevated risks were identified.

2.8. One respondent referred to the fact that, going forward, an increasing proportion of gas and electricity meters would be operated by businesses which are not subject to the same level of regulation as network operators and another commented that network regulation does not extend to district heating infrastructure which is often installed in conjunction with electricity plant and equipment. However, whilst valid points to make, we consider that these issues fall outside the scope of this review and note that both areas are subject to separate review and discussion.

2.9. We deal with particular comments and suggestions under the section for each licence condition in chapters 3 and 4 below.

⁸ Revenue = Incentives + Innovation + Outputs (RIIO)
<http://www.ofgem.gov.uk/Networks/rpix20/Pages/RPIX20.aspx>

Views expressed at our industry workshop

2.10. In May 2010 we held an industry workshop to discuss the background to our initial proposals with NWOs and to review the responses we had received. It was a useful opportunity to explore concerns which had been raised and to explain some of our objectives. In particular, we sought to allay concerns by clarifying that:

- our proposals in respect of independent directors are not intended to impinge on legitimate control of NWO businesses by their owners, and
- our proposals do not reflect a view that energy administration should be a measure of early resort.

2.11. The workshop covered each of the ring fence conditions and a number of useful suggestions and comments were made which we have incorporated into the proposals in this document. A key area of discussion related to our initial proposal that NWOs should be required to have a majority of independent directors on their boards and a number of alternatives were explored.

2.12. More detail on the issues covered at the workshop in relation to each of our proposals is given in chapters 3 and 4 below. Attendees also requested sight of early drafts of modification proposals so that they could provide input to the drafting process.

NWO comments on early draft conditions

2.13. Following a suggestion at the May workshop referred to above, in October 2010 we informally circulated some specimen draft conditions to NWOs to obtain feedback on our expected approach to drafting. We made clear that comments could be made on issues of drafting without prejudice to responses to the consultation on our proposals (this document) and we appreciate the contributions made in that context.

2.14. The draft conditions circulated in October broadly anticipated the updated proposals set out in this document. In particular, they reflected our developing view that NWOs should be required to have two sufficiently independent directors (SIDs), as opposed to the majority of independent directors we had referred to in our initial consultation publication.

2.15. In that context one NWO group suggested that, instead of a requirement for SIDs, there could be a requirement for an independent auditor to report on the certificate prepared by the NWO's board before the declaration/payment of a dividend. Another group suggested that NWOs with a UK listed parent company, subject to the UK Corporate Governance Code, should be exempt from a requirement for SIDs.

2.16. Some respondents agreed with our removal of references to existing licence conditions relating to the independence of NWO businesses. We had originally thought that it might be appropriate to incorporate any requirement for independent directors into those conditions. However, on review, we noted that these conditions are primarily intended to address the risks associated with possible abuse of an NWO's

monopoly position and to safeguard against improper cross subsidies or discrimination, particularly with regard to relationships with affiliate energy shippers or retailers. Although these are important areas, they are separate from the governance and financial stability issues being addressed by these proposals.

2.17. We have included most of the feedback from the early draft licence condition circulation in the *consideration of feedback* sections in chapter 3. However, we have expanded on the two suggested alternatives to a SIDs requirement (audit report on pre-dividend certificates and reliance on group level corporate governance) at the end of chapter 4.

3. Modifications to existing ring fence conditions

Question box

Question 1: Do our proposed changes to the existing ring fence conditions effectively address the risks which we have identified in a proportionate way?

Question 2: Have we satisfactorily addressed the responses to our initial consultation in terms of the impacts and alternatives which were raised?

Question 3: Do you think that our proposals will enhance the synergic working of the ring fence and the concept of a defence in breadth and depth against financial or operational distress?

Question 4: Do you agree with the exceptions to applicability we have set out for certain types of NWO?

Question 5: Have we drafted conditions which are clear and concise – or are there improvements that we could make?

Introduction

3.1. This chapter describes in more detail our proposed modifications which would affect four of the six existing ring fence conditions. It also gives our reasons for proposing no changes to the two remaining ring fence conditions (restriction of activity and financial ring fencing and credit rating requirement). We also explain why we are proposing that some modifications should not apply to particular types of NWO.

3.2. Our aim has been to draft modifications which would apply the ring fence changes on a consistent basis for different categories of NWO. We are not, however, proposing to redraft whole conditions to make them fully consistent across licence types since this could set up inconsistencies of style and content within the individual licences. We are though proposing to make some changes to correct drafting issues identified during the review process (such as updating references to legislation) and/or to bring phrases into line with current drafting style. As with the substantive proposed changes, we would welcome comments on any of these points which are shown on the draft conditions in the separate appendices document.

3.3. It should be noted that the descriptions of conditions and proposed modifications given in this chapter are necessarily general in nature. Reference should be made to the full text of existing conditions for details of their requirements (see associated documents c to f) which vary in their detail between different types of NWO.

Disposal of and charges over assets

Existing condition

3.4. The present ring fence condition covering asset disposals prohibits NWOs from disposing of network assets (including control centres) or granting security rights over them. This applies even where a disposal would be for full consideration and on an arms length basis. There are, however, some specified exemptions to the restriction and it is also open to the Authority to consent to proposed disposals either on a case by case basis or by giving a general consent to a category of transactions.

3.5. The restriction is intended to ensure that ownership, management and operational control of network infrastructure by the regulated company is not surrendered or encumbered by third party security rights. It is relevant to note that, unless conditionality is imposed on/accepted by an acquiring party or chargee at the time a consent is given, it would generally be open to that party to sell on the assets or assign the benefit of a charge to another party at a future time.

Proposed modification (see also Appendix 10 for draft of modified condition)

3.6. We are proposing that the restriction on the granting of security interests should be extended to cover the NWO's receivables (contractual rights to receive cash and other financial assets from other entities). This is the same proposal as we initially set out, but we now refer to 'receivables' instead of 'debtors' because this description is consistent with international accounting standards and is more easily defined and understood. As with the existing restriction affecting network assets it would be possible for the Authority to consent to the granting of security upon receipt of a notice of intent from the NWO. The drafting makes clear that existing charges can remain in effect and be varied, provided that the scope is not materially extended.

3.7. To be effective, charges over company assets generally have to be registered at Companies House. Most charges (often in the form of loan debenture instruments) are registered as 'fixed and floating' charges. The charge over a company's receivables would generally be covered by the floating charge part of such an arrangement, since it is generally necessary for a company to turn over its debtors in the course of trading. Our drafting of the proposed condition (see Appendix 10) would prohibit the granting of a charge over receivables without consent, but would not impinge on normal business transactions relating to receivables.

Reasons for proposal and consideration of feedback to date

3.8. Restricting the circumstances in which an NWO's receivables can be subject to security means that, in a financial distress event, there should be more unencumbered financial assets available, in particular relating to income from extant use of system charges. It would remain open to NWOs to grant security over other classes of assets such as office buildings or vehicles. The proposed restriction would also reduce the

likelihood that a creditor of an NWO could hold a qualifying charge i.e. one conferring the right to appoint an administrator⁹ in the event of a payment default.

3.9. One respondent to our initial consultation felt that restricting the granting of charges over receivables was not justified because the existing Indebtedness restrictions already prevent inappropriate charges being granted. The Indebtedness condition prohibits the granting of charges unless they are on normal commercial terms and for the purpose of the network business. In the same vein, another respondent suggested that rather than imposing a general restriction on the granting of charges over receivables, we should adopt an approach of restricting particular types of transaction.

3.10. We feel, however, that ownership groups enjoy considerable flexibility regarding intra-group financing arrangements which can affect NWOs, and receivables constitute a key asset class on NWO balance sheets which ought not to be affected by security rights. As mentioned above, this view applies to trade receivables as well, because these represent an important source of working capital which should remain available to NWOs in all circumstances.

3.11. A further respondent commented that our proposed additions to the Availability of Resources condition would make this restriction unnecessary. It is true that there are a number of overlaps between our proposals but this is consistent with the synergic/defence in breadth character of the ring fence which we are seeking to promote, as referred to at paragraph 1.11 of Appendix 2.

3.12. Some respondents were concerned that the proposed restriction could restrict financing options which could push up NWOs' cost of debt. However, the fact that there are few existing instances of NWOs granting charges which cover receivables suggests that a new restriction should not be problematic for businesses in normal circumstances, and the cost of debt allowed to NWOs has not historically factored in any assumption that lenders will be granted security at NWO level. We consider that augmenting this aspect of the ring fence should be supportive of diversity in corporate financial and operational arrangements because it will help to manage the regulatory risks associated with receivables on the NWO's balance sheet. However, the notice/consent mechanism embodied in the licence means we would be able to consider any notice of intent to grant a charge on its merits in the particular circumstances.

3.13. Our proposal is that this restriction would apply to all NWOs except OFTOs. Unlike other NWOs, OFTOs will often receive investment under project-financing arrangements which might be frustrated by the proposed restriction. Project financing reflects the particular nature of OFTO network operation, with a single transmission line connecting an offshore generation facility to onshore transmission or distribution networks.

⁹ The holder of a qualifying charge (under Schedule B1 to the Insolvency Act 1986) seeking to appoint an administrator to an NWO would have to give 14 days notice to the Secretary of State and to the Authority, during which time application might be made for the appointment of an energy administrator under the special administration regime.

3.14. One respondent to our earlier consultations made the point that the effective start date for any restriction should be made clear so that existing charges are not caught. Our drafting provides for this so that the date after which charges would not be allowed to be granted would be clear.

Availability of resources

Existing condition

3.15. This condition requires the NWO to ensure that it always has available to itself, the financial and other resources needed to carry on its network business and comply with its licence conditions.

3.16. The licensee's board is required to provide a certificate by 31 July each year confirming its reasonable expectation that the NWO will have sufficient financial resources and facilities to carry on the network business for the next 12 months. The directors also have to provide a statement setting out the factors which the board has taken into account in giving the certificate. In addition, the certificate must be accompanied by a report from the NWO's auditors stating whether or not they are aware of any inconsistencies between the certificate/statement on the one hand, and information they obtained in auditing the NWO's regulatory accounts¹⁰ on the other. The NWO is required to inform Ofgem immediately if any circumstances arise which undermine the terms of the certificate which has been given.

3.17. The condition also requires the board of the NWO to provide a further certificate before it declares or pays a dividend (or makes any other kind of distribution). This certificate refers to the directors being satisfied that the NWO is compliant with six key licence conditions (including five of the ring fence conditions) and that the dividend payment will not cause the licensee to become non-compliant. It is pertinent to note two points in relation to dividend payments:

- since NWO dividends are paid to their corporate shareholders, the payments are effectively intra-group transactions, and
- the pre-dividend certificate referred to above can be submitted immediately before the payment is made, so it does not provide any period of notice.

Proposed modification (see also Appendix 11 for draft of modified condition)

3.18. We are proposing that the annual certification requirement should be extended to cover operational/business resources and compliance status regarding the six key licence conditions already referred to in pre-dividend certificates (see paragraph 3.17). As with the present certificate which refers only to financial resources and facilities, the expanded certificate would be on a forward looking basis, addressing the following 12 month period. The obligation for the NWO to report any adverse circumstances affecting the most recent certification would be similarly extended. We are also

¹⁰ Financial statements required under NWO licenses which are broadly consistent with statutory accounts but which are prepared with respect to regulatory years and which may include additional reporting requirements.

proposing a drafting change to make clear that the NWO should report any worsening of the circumstances which gave rise to the submission of a negative certificate in the form of 'Certificate 3'.

3.19. The statement of the main factors taken into account by the NWO's directors would be extended to apply to the operational/business resource certificate, but the requirement for an auditor's report on consistency between the annual certificate and information the auditor obtained during his/her work on the licensee's Regulatory Accounts would continue to apply only to financial resources and facilities.

3.20. In addition, we are proposing that NWOs should be required to maintain an Intervention Plan providing key financial and operation information which could be accessed by NWO management in contingencies. However, the plan can rely on references to other documents and records provided they are readily accessible by the NWO's managers.

3.21. Our proposals in relation to this condition would apply to all types of NWO.

Reasons for proposal and consideration of feedback to date

Expanded annual certificate

3.22. Under our proposals, the expanded scope of the annual certificate would mean that the NWO (acting through its board) would need to formally consider the health of important contractual relationships, including those with resource providers who are affiliates or related parties as well as the resources under its direct control. In this context it is important to note that the condition refers to the NWO's directors having *reasonable expectations* concerning the sufficiency of resources. This means that directors can properly make the certificate even though there may be known business risks, for example in contractual relationships with third parties, provided those risks are being properly managed in all the circumstances. NWO managers already have to make judgements on future resourcing requirements in relation to the going concern statement in the NWO's statutory accounts and in relation to the detailed business plans they submit to us during price control reviews. Sufficiently independent directors on the NWO board (see proposal in chapter 4) could make a valuable contribution to this aspect of governance.

3.23. Most respondents to our consultation appreciated the rationale for extending the scope of the annual certification requirement. One respondent did however wonder how it would actually reduce risk and noted that Ofgem could check on compliance with the overall resourcing requirement at any time. We acknowledge this point but whilst we are working to improve our monitoring of financial capacity and resourcing issues, this is no substitute for scrutiny by the NWO's own board.

3.24. The new requirement should not be unduly onerous because it does not impose any new resourcing requirements on NWOs who are already required to ensure that they always have available all of the financial and operational resources required to carry on the network business. However, it does formalise the NWO board's duty to regularly examine compliance with this requirement which should be of benefit to all stakeholders.

3.25. A number of NWOs made the point that it would be problematic and costly to obtain an audit report relating to the adequacy of operational resources because of the more subjective nature of this issue compared to financial resources. We have accepted this point and, as noted in paragraph 3.19, the requirement for an auditor's report would not apply to this part of the annual certificate.

3.26. Some respondents expressed the view that the risk associated with major contractors and affiliate resource providers was being over stated in our proposals whilst others stated that it would be difficult for NWO managers to assess risks embedded in major third party contractors. Another point made was that there should be guidance on the level of 'due diligence' to be carried out in making the certification. One respondent particularly referred to the range of "factors which may cast doubt on the licensee's ability to carry on the Distribution Business" in the context of a qualified certificate.

3.27. Whilst we understand the reason for these concerns, we do not believe there will be a need to issue specific guidance on these issues. It should be relatively straightforward for the NWO's board to decide what, if any, enquiries it needs to make before certifying a reasonable expectation that the NWO will have sufficient operational resources to carry on the network business for the next 12 months and there is a great deal of guidance available for directors on the extent of their responsibilities in the context of companies legislation. However, it's worth clarifying that we would not expect a certificate to be qualified in respect of generally known issues which could indirectly affect network operations over longer timescales, such as climate change.

3.28. One respondent suggested that instead of extending the annual certificate to cover operational resources, we could tighten the restrictions and undertakings which apply to any relinquishment of operational control over network assets by an NWO to an affiliate resource provider. We consider, however, that our proposal better addresses the risk presented by the more diverse business resourcing arrangements developed by businesses in recent years, and is consistent with our view that it is for the owners, and boards of NWOs to manage the network business and ensure its financial and operational well being.

3.29. A further comment made was that the infrastructure comprising independent distribution networks is newer on average than that in GDN/DNO networks so that they are less prone to operational failures and that construction projects for IDNO networks are often carried out by a third party which removes construction risk from the IDNO. Whilst these are valid points, they only really highlight that different NWOs will have different risk factors associated with their network operation and which need to be taken into account in the annual certification process.

3.30. One finance provider suggested that certificates could be placed in the public domain by NWOs. For this to happen, it would probably have to be required under a licence condition and there would undoubtedly be issues of commercial sensitivity. It is not something we are proposing, but we would be interested to receive comments on the scope and format of information which could be published by Ofgem and NWOs in relation to the ring fence conditions.

Intervention plan

3.31. Our proposal is intended to ensure that if, in any contingency, a new management team had to take over an NWO and the operation of its network business, a compilation of key financial and operational information about the business would be readily available.

3.32. Our draft condition proposes that the Intervention Plan should contain information which would be sufficient to allow an energy administrator (within the meaning of Chapter 3 of Part 3 of the Energy Act 2004) readily to obtain information on key aspects of the NWO's business and finances. This drafting is intended to provide an acid test of the information which ought to be included on the basis that an energy administrator would be required to quickly move from having little or no knowledge of a business to taking over its affairs in a short period. However, this reference to a financial distress event does not mean that we consider such an event to be likely nor that an Intervention Plan would only be of use in such circumstances (see comments at paragraph 1.10 of Appendix 2). In our initial consultation we referred to a "living will" but we have changed the requirement title because we considered that name suggested a winding-up scenario which might apply to a failing financial institution but which would be very unlikely to apply to an NWO.

3.33. A number of NWO respondents felt that the costs of an intervention plan would outweigh the benefits and several NWOs indicated that they already maintain records of the nature referred to as part of their disaster-recovery planning. Although financial distress in an NWO could be considered a high impact/low probability risk, we consider our proposals are warranted because they should ensure that a set of key management information, relevant to the NWO is available at all times. There was general feeling that clear guidance was needed on what the plan should contain but that this should not be overly-prescriptive. We have therefore drafted the condition to include a schedule of areas which the plan should cover, but without specifying the particular type or format of records which should be included. It would be for the NWO's management to decide on these points and to ensure the plan was kept up to date. Our expectation would be for plans to be kept as simple as possible provided they met the requirements set out. We have not included any requirement for submission of the plan to Ofgem; however, the plan would be likely to be discussed during regulatory visits/meeting with companies.

3.34. Our view is that the requirement to maintain an Intervention Plan should apply to all NWOs, including independent distributors. Some IGTs have hundreds of thousands of connected customers and, even for distributors with fewer customers, the requirement to prepare and maintain a set of records is justified. We would however, expect the plans prepared by smaller distributors to be relatively simple, reflecting the nature of their businesses. As mentioned at paragraph 3.20 the Intervention Plan can refer to information in separate documents records. We have considered whether it should also be able to refer to the knowledge and expertise of individuals working for or with the NWO. However, whilst we think it more likely that managers and personnel would remain with an NWO experiencing financial distress than, say a bank in similar circumstances, we think it would be unwise to place undue reliance on that assumption.

Ultimate controller undertakings

Existing condition

3.35. This condition requires the NWO to obtain a legally enforceable undertaking from each of its ultimate controllers saying that they will refrain from taking any action that would be likely to cause the licensee to breach, as applicable, the Gas Act 1986 or Electricity Act 1989 or its licence and act to ensure that other subsidiaries of the ultimate controller also refrain from such actions. The undertaking should therefore serve as a shield against group or ownership influence which is contrary to the interests of the NWO. The term ultimate controller is defined in the licenses and, as well as the top company in the licensee's group, includes any person who can control or exert significant influence over the NWO under contractual or ownership rights.

3.36. The undertaking takes the form of a deed between the ultimate controller (as covenantor) and the NWO. The NWO must obtain the undertaking within seven days of a party becoming an ultimate controller and provide a copy of it to the Authority. The Authority can direct the NWO to enforce the terms of the undertaking and the NWO must tell the Authority straight away if there is any breach of the undertaking or if its terms become unenforceable. The NWO is not allowed to enter into agreements/arrangements with an ultimate controller or its subsidiaries when there is no undertaking in place or there is an un-remedied breach of an undertaking.

Proposed modification (see also Appendix 12 for draft of modified condition)

3.37. In our initial consultation we suggested that NWOs might be required to novate each of their ultimate controller undertakings on a periodic basis, regardless of whether the parties to them had changed. However, nearly all of the NWOs who responded to that publication said that such a requirement would be unduly onerous, particularly for those businesses whose ultimate controllers are overseas corporations or funds.

3.38. We acknowledge that a requirement to have documentation re-drafted and signed when there have been no substantive changes to the position could be disproportionate. Therefore, as suggested by one respondent, we are instead proposing that, in addition to the existing requirements, each NWO should, by 31 July each year:

- provide us with a list of its ultimate controllers, and
- confirm that it has sent a letter to each of those ultimate controllers re-apprising them of their responsibilities under their undertakings.

3.39. The form of the letter referred to above would be a matter for the NWO's board but we envisage that it would be straightforward in nature. The proposed requirement would apply to all types of NWO.

Reasons for proposal and consideration of feedback to date

3.40. In our initial consultation we asked for views on whether ultimate controller undertakings should have to be updated and resubmitted to Ofgem at periodic intervals even where the parties remain unchanged. The thinking behind this was that it could keep the terms of the undertakings at the forefront of management attention and act as a stimulus to obtain new undertakings when required. We believe that our revised proposal will serve to reaffirm the importance of the undertakings both at NWO and ultimate controller levels. It should also prompt NWOs to obtain any new undertakings which may be required, bearing in mind that there can be more than one ultimate controller and the definition embraces any person who can control or exercise significant influence over the NWO or any of its holding companies.

3.41. One respondent commented that the value of ultimate controller undertakings derived from their status as legally enforceable deeds, and that an annual reminder of the undertaking given would not add much. We consider, however, that a regular reminder of the terms of the undertaking given by the NWO's board would constitute an effective preventative measure which could reduce the likelihood of an NWO needing to seek a legal remedy to a problem. This may be particularly relevant where NWOs have overseas owners and legal processes could be complicated by issues of jurisdiction.

3.42. NWOs are also required to obtain an undertaking from their ultimate controllers under separate licence conditions, relating to the provision of information to the Authority. We considered whether this undertaking should be included in the proposed requirements but decided that it should not because:

- compliance with the condition which refers to the provision of information undertaking is included in the certification requirements under the Availability of Resources condition (including the augmented annual certificate which we are proposing – see paragraphs 3.17 and 3.18), and
- the provision of information condition is not one of the ring fence conditions we are considering in this review.

Restriction of indebtedness

Existing condition

3.43. This condition is designed to ensure that an NWO only takes on indebtedness for the purposes of the network business and on normal commercial terms. It also sets out the kinds of payments, loans and asset transfers which an NWO is allowed to make to an affiliate or related undertaking. These stipulations are at the heart of the ring fence and serve to regulate and formalise the financial relationship between the NWO and the corporate group to which it belongs. When corporate transactions take place which affect an NWO, such as a change in ownership of its shares or those of a holding company, we check that any revised financial arrangements are compliant with the restriction of indebtedness condition.

3.44. If an NWO is affected by adverse financial developments, demonstrated by the loss or prospective loss of its investment grade credit rating, further restrictions apply to the types of payments and asset transfers it is allowed to make to affiliates or related undertakings without consent from Ofgem. These additional restrictions are known as the *cash lock up* and, in general terms, preclude payments and transfers (including assets, rights and benefits) which are elective, such as dividends, or where tangible consideration for the payment/transfer is not received at the same time. Finance providers have indicated to us that they view the cash lock up as an important regulatory provision.

Proposed modification (see also Appendix 13 for draft of modified condition)

3.45. Our proposal in respect of the Restriction of Indebtedness condition involves adding two more categories of trigger event to the 'cash lock up' mechanism. The proposal would apply to all types of NWO.

Additional trigger 1: adverse availability of resources submission

3.46. The first additional lock up category links across to the Availability of Resources condition (see paragraphs 3.15 to 3.34 above). The lock up would apply if:

- (i). the NWO provides an annual certificate in relation to the availability of resources in which the board expresses an opinion that the NWO will not have sufficient financial and/or operational resources for the next 12 months or is not compliant in all material respects with the stipulated licence conditions ("Certificate 3"), or
- (ii). the NWO informs us that the board has become aware of any circumstances causing them no longer to have the reasonable expectations expressed in a preceding positive certificate ("Certificate 1" or "Certificate 2").

3.47. In either case, the lock up would be released when the NWO's board submitted a positive certificate ("Certificate 1" or "Certificate 2"). This could be done at any subsequent time – the board would not have to wait until the next scheduled certificate submission.

Additional trigger 2: breach of a financial covenant

3.48. The second additional category relates to a material breach by the NWO of any financial covenant with a bank or other financial institution. However, the lock up would not apply where the NWO had:

- (i). remedied the breach to the satisfaction of the counter party and notified us of the position in writing, or
- (ii). renegotiated the terms of the covenant to the satisfaction of the counter party and notified us of the position in writing, or

- (iii). obtained advance confirmation from us that a particular breach would not trigger the lock up.

Reasons for proposal and consideration of feedback to date

3.49. Our main reason for proposing the additional cash lock up triggers outlined above is that we consider that the existing condition depends too much upon prompt and appropriate changes to an NWO's credit rating. Whilst the credit rating test remains a useful trigger, the recent financial crisis illustrated that the rating process is not foolproof and there are risks in placing undue reliance upon it, particularly in relation to purposes for which it is not primarily intended. In that context it is pertinent to note that much of the debt finance utilised by NWOs is actually raised by parent companies and on-lent to the licensee or an affiliate resource provider.

3.50. In our earlier consultation we also touched upon a degree of circularity between regulatory requirements and credit ratings. For example, on the one hand, an NWO's credit rating may be enhanced to some extent because of the existence of the regulatory ring fence and, on the other hand, the ring fence conditions make reference to credit rating status as a requirement. This does not need to be an issue of concern, provided that it is recognised and taken into account. Indeed, the revised cash lock up mechanism would still have some weaknesses associated with it; for example, breaches of financial covenants elsewhere in the NWO's group would not trigger a lock up. However, it forms a useful part of the ring fence regime, bearing in mind the defence in breadth and depth approach we have previously referred to, and the additional triggers we are proposing will enhance its contribution. Notwithstanding these points, some respondents to earlier consultations felt that credit rating status alone remains an adequate trigger for the cash lock up provisions because it should reflect all of the factors pertinent to a company's financial capacity.

3.51. Several respondents raised a concern that a precipitous cash lock up could itself be a catalyst for financial distress and suggested that the scenarios set out should perhaps trigger the provision of additional information to Ofgem rather than a cash lock up. However, we do not believe that the regulatory cash lock should in itself cause or aggravate financial problems because it only restricts elective or under value payments/transfers to affiliates when an NWO is already affected by adverse financial or operational circumstances to some extent. We have also made sure that the circumstances in which the lock up restrictions would apply are clearly set out in the draft condition to avoid uncertainty which might be associated with any discretionary lock up mechanisms.

3.52. A further suggestion was that instead of proposing the additional cash lock up triggers, we could restrict the type of group treasury arrangements utilisable by NWOs. A comment was made that ratings agencies would take into account a situation where a company deposited cash with a non-investment grade affiliate. However, whilst it is undoubtedly appropriate for NWOs to have treasury arrangements which promote compliance with the ring fence conditions, we consider that these arrangements are a matter for business managers. Prescriptive requirements would represent the more interventionist approach which we have decided against and which most respondents to our initial consultation were firmly against.

3.53. Some independent distributors suggested that the additional triggers should not apply to IGTs or IDNOs because they are subject to cash in escrow arrangements as an alternative to the requirement to hold an investment grade issuer credit rating. Whilst it is true that these requirements do mean that, in the case of IGTs and IDNOs, a certain amount of cash is reserved for financial distress contingencies, we consider that the proposals should apply to all types of NWO because they should serve to stabilise the financial position at a relatively early stage and should not be unduly onerous either in operation or in their 'standby' mode.

Breach of a financial covenant

3.54. Our original proposal envisaged the lock applying if an NWO renegotiated the terms of a covenant to avoid a breach. A number of NWOs pointed out that some covenant renegotiations are trivial in nature and others may even reflect a positive change to circumstances. In light of these points we have changed our drafting so that renegotiation of covenants would not trigger a cash lock up and we now also refer to a triggering breach being *material* in nature. We have also made clear that the reference is to financial covenants with banks or other finance providers and not to other kinds of contractual terms and conditions.

3.55. Some respondents said that financial covenants themselves sometimes impose forms of lock up when breaches occur, and 'standstill' agreements put in place after a breach may also impose conditions on the borrower. This might also result in other financial disciplines being applied by a lender, such as restrictions on granting security or paying dividends. However, these are likely to be framed in terms which protect the interests of the particular lender and may not align with what we are seeking to achieve. For example, after a covenant breach a company might still be allowed to make early debt repayments to a parent or affiliate whereas this would generally be prohibited under the cash lock up in the licence.

3.56. Another concern raised was that NWOs might be deterred from entering into covenants if they were associated with a cash lock up trigger and this could have the effect of restricting finance options, in turn pushing up costs. There was therefore a suggestion that a covenant breach could trigger a notification to Ofgem rather than a cash lock up. We think it unlikely, however, that the possibility of cash lock up in the case of a breach would dissuade NWOs from entering into appropriate financial covenants.

3.57. A further representation made was that the wording of any proposed modification should make clear that the new trigger would not have retrospective effect. Our proposed drafting means that the additional trigger would not apply to covenant breaches which had arisen before the modifications came into effect but we consider that it should apply to post-modification breaches of existing financial covenants.

3.58. We agree with feedback on the early draft condition we circulated that NWOs should be able to avoid lock up by notifying us of a renegotiated position without having to wait for formal acknowledgement from us of their notices and we have drafted the revised condition accordingly. However, where the NWO seeks pre-clearance of a prospective breach circumstance, it would need to obtain a written response from us before the breach occurs to avoid a lock up.

Adverse availability of resources submission

3.59. In response to feedback, we have drafted the proposed modification so that the cash lock would not be triggered by an annual availability of resource certificate in the form of Certificate 2, in which the directors state that they have a reasonable expectation that the licensee will have sufficient financial and other resources for the following 12 months but draw attention to factors which may cast doubt on the ability of the NWO to carry on its licensed activities. We agree that such a certificate should in the first instance be a trigger for discussions between the NWO and Ofgem.

3.60. One response to our earlier consultation said that a certificate referring to a deficiency in operational/business resources (as opposed to financial resources) should not trigger the cash lock up. Our view is that it should for two reasons:

- the cash lock up covers transfers of assets as well as payments of money, and
- if an NWO is potentially short of operational resources, for whatever reason, a restriction on non-essential or premature payments/transfers (backed up by the ultimate controller undertaking) will assist in resolving the deficiency position.

3.61. It is relevant to note that an NWO would already be prohibited from paying a dividend in circumstances where a shortage of operational/business resources was in prospect because the existing pre-dividend certificate requires the board of the NWO to certify that it is compliant with the Availability of Resources condition generally and that the making of a distribution would not be likely to cause a breach of the condition.

Release from cash lock up

3.62. Feedback also suggested that there should be clear unlocking mechanisms in relation to any new triggers and we feel that we have addressed this point in our drafting as referred to at paragraphs 3.47 and 3.48 above.

Credit rating requirement

3.63. We are not proposing any changes to this condition.

3.64. In our March 2010 initial consultation we acknowledged risks associated with the use of credit ratings as a barometer of financial health and as a trigger mechanism for the 'cash lock up'. These issues reflect the fact that ratings are primarily intended to reflect the repayment risk associated with corporate debt and are to some extent subjective and retrospective. However, we think the requirement for NWOs¹¹ to maintain an investment grade rating should remain because:

¹¹ The Authority can specify alternative arrangements for independent distributors for whom the acquisition of an issuer grade rating would be impracticable.

- notwithstanding the limitations referred to above, issuer credit ratings provide a metric which is based on well resourced expert analysis,
- credit rating criteria remain of relevance in the assessment of financeability for price control modeling,
- the loss of a rating could provide an avenue for enforcement action in relation to financial issues in some circumstances,

3.65. These factors mean that the credit rating requirement adds significant value in the synergic/defence in breadth context for the ring fence regime which we have referred to earlier in this paper. In addition, most NWOs would have to maintain a rating, even if the licence requirement did not exist so that they could raise finance through debt issues. In that regard, the marginal costs associated with the requirement, and which are ultimately paid by consumers, appear justified.

Restriction of activity and financial ring fencing

3.66. We are not proposing any changes to this condition which prohibits NWOs from carrying on activities that are not part of the network business¹². It also restricts the shares and other investments which an NWO can acquire or hold to those associated with the network business, its financing or treasury operations.

3.67. We currently consider that the requirements of this condition are clear and effective in preventing NWOs from becoming involved in activities or investments which could impinge on the proper management and operation of their network businesses or involve undue commercial risk.

¹² An NWO is allowed to conduct some non-network business activity ('de minimis' business) limited to 2.5% of its total turnover and investment at a level of 2.5% of its share capital and reserves.

4. Sufficiently independent directors

Question box

Question 1: Do you think our revised proposal to require NWOs to have two sufficiently independent directors (SIDs) is proportionate and addresses the risks we have identified particularly in relation to possible conflicts of interest?

Question 2: Does our revised proposal alleviate the concerns about legitimate influence and control by NWO owners raised in relation to our initial proposal to require a majority of independent directors?

Question 3: Do you have any comments on the alternative approaches which are referred to?

Question 4: Is our draft condition for sufficiently independent directors clear and concise, or could the drafting be improved?

Question 5: If a requirement for SIDs is introduced, how much lead time do you think should be allowed for candidates to be selected and appointed?

Question 6: Do you agree that the proposed condition for sufficiently independent directors should not apply to independent gas and electricity distribution network operators nor to offshore transmission operators?

Proposed requirement for sufficiently independent directors

4.1. In our initial consultation and impact assessment published in March 2010 we said that we were considering a proposal that NWOs should be required to have a majority of independent directors on their boards to help guard against possible conflicts of interest in respect of the fiduciary and other duties of directors where they sit on the board of both the NWO and related parties within its ownership group. We received a considerable amount of feedback on this suggestion and our current proposal has been significantly developed in light of the concerns and suggestions which have been raised and which are considered in detail below.

Proposed licence condition (see also Appendix 14 for draft of condition)

4.2. Our proposal is that all NWOs, except OFTOs, IGTs and IDNOs, should be required to have at least two 'sufficiently independent directors' (SIDs) on their boards. The SIDs would have to be natural persons (i.e. not companies) and have the skills, knowledge, experience and personal qualities necessary for them to perform effectively as non-executive directors of the licensee as well as characteristics of independence. Our proposed licence condition sets out criteria which we consider would establish the right degree of independence. Those criteria are that a SID:

- must not be or have been a director or employee of the NWO or any of its affiliates or related undertakings in the 12 months before his/her appointment (but this does not include an appointment as a SID of an affiliate NWO),
- must not have, or have had in the 12 months before appointment, any material business relationship with the licensee or any affiliate or related

- undertaking (but this does not include the holding of a small number of shares in one of those companies),
- must not represent the particular interests of any shareholder or group of shareholders of the licensee or the interests of any affiliate or related undertaking of the licensee, and
- must not receive remuneration from the licensee or any affiliate or related undertaking of the licensee apart from a director's fee and reasonable expenses (but the restriction does not include benefits such as pension rights accrued from previous service with the licensee, or an affiliate or related undertaking).

4.3. The NWO would have 14 days to notify us of SID appointments and a similar period within which to notify removals or resignations, with the reason for that event. A SID appointment could be for up to eight years, with reappointment possible after that. NWOs and SIDs (under a condition of appointment) would be required to use their best endeavours to ensure that the appointee remained sufficiently independent during his/her term of service. In our view a moratorium of 12 months between a person working for an NWO (or affiliate) and eligibility for appointment as a SID means that the pool of candidates can include experienced former employees of network/energy businesses whilst an appropriate standard of independence is maintained.

4.4. The drafting of the proposed condition provides for an effective start date for the requirement and we seek comments on how long a lead time companies might require to select candidates and put necessary administrative arrangements in place. As with most of the other ring fence conditions, the drafting would allow Ofgem to consent to derogations from compliance in exceptional circumstances. However, in order to ensure that requirements are clear, we have decided not to include any 'comply or explain' elements.

Reasons for proposal

4.5. We have made a significant move away from our initial proposal that NWOs should be required to have a majority of independent directors. We have listened to concerns, principally expressed by the owners of NWOs that requiring a majority of independent directors would seriously interfere with their rights of control. It was not and is not our intention to require NWO boards to be constituted so that they could or should act independently of proper influence and control by the NWO's owners. We do acknowledge that, even though the choice of independent directors would remain with an NWO's owners, a requirement for a majority of independent directors could affect owners' ability to have the network business run and managed in a way they would consider to be efficient and desirable. We also accept that, in practical terms, NWOs are bound in, to a greater or lesser extent, to group business arrangements and these relationships provide benefits for consumers and other stakeholders. However, we consider that SIDs should be able to make a positive contribution to good governance, particularly in promoting the importance of licence compliance (letter and spirit) which is central to the NWO's business. Our proposal is also consistent with the view that it is for the owners and directors of NWOs to manage licence compliance and financial stability issues and that more interventionist regulatory measures are undesirable.

4.6. In the sections below, we refer to tensions which could arise where individuals hold appointments as directors or managers of multiple companies across a corporate group. This would be most likely to be the case if the group's businesses were experiencing operational or financial distress. Those individuals might naturally feel that their loyalty should be to the wider business and this could entail the taking of risks in relation to the NWO for the perceived good of that wider business. A person who is only appointed as a director of an NWO (within a group) is less likely to become confused about where his or her duties lie than someone who owes director's or executive duties to both the NWO and a parent or affiliate. SIDs should therefore always be in a position to provide a 'voice of reason' at board meetings in relation to the needs of the NWO. It is worth emphasising that our proposals are not meant to cast any aspersions on the directors or managers of NWOs or affiliates.

4.7. Some respondents to our earlier consultations pointed out that the undertaking provided by ultimate controllers should mean that NWOs would not be compromised by the needs of other parts of a group business. This is a fair assertion and the conditions covering ultimate controller undertakings are an important constituent of the ring fence regime. However, in sufficiently serious situations, trading pressures could mean that group level owners might be less mindful of the terms of ultimate controller undertakings than would normally be the case. It is pertinent to note that if, in extremis, an NWO had to enter special administration, there is a possibility that public funds might have to be committed to ensure the continuity of network operations.

4.8. Some respondents also said that SIDs would in any case have limited power to prevent decisions being taken which they considered to be against the particular interests of the licensee, including the payment of a dividend, because they would probably represent a minority on the board and could be replaced by the NWO's owners if they demurred from its requirements. The point was made that the only weapon which would be available to a SID would be to resign and in that sense they might be no better than 'canaries in a mineshaft'. There is a risk that, in some circumstances, comments by SIDs might be ignored. However, our drafting of the proposed licence condition means that the NWOs would have to inform us if SIDs resigned and make fresh appointments as soon as possible. It would also be open to SIDs to make representations within the NWO's corporate group or to contact us if they had concerns about compliance related issues and this should allow for management or regulatory intervention. We are not, however, seeking to specify any particular circumstances in which it would be appropriate for whistle blowing to take place.

4.9. We have considered whether a requirement for a single SID would adequately address the risks we have identified. We believe the proposed requirement for two SIDs is justified for two reasons. Firstly, two or more SIDs would be able to provide a degree of mutual support particularly in testing circumstances, and secondly if one of the SIDs was unable to perform his/her duties for a period of time, perhaps because of illness, there would still be an independent presence on the board. We would however, be interested to hear the views of stakeholders on this point.

4.10. We also consider that our proposals will be consistent with the aspects of the third package of EU Directives¹³ on energy markets which relate to independence:

¹³ Directive 2009/72 and 73/EC of the European Parliament and of the Council of 13 July 2009

- the need to ensure independence (in terms of legal form, organisation and decision making) of transmission and distribution system operators, and
- the need to ensure that the professional interests of persons responsible for the management of transmission and distribution systems are taken into account in a manner that ensures that they are capable of acting independently.

Things we are *not* proposing

4.11. It is relevant to note a number of things which are pointedly not included in or implied by our proposal.

4.12. SIDs would not have any particular duties with regard to licence conditions (save in relation to their characteristics of independence). They would have the same legal duties as other directors and it would be for the NWO and its shareholders to decide on the range of non-executive responsibilities which appointees should have. We did contemplate proposing a requirement for SIDs to have reserved powers on some regulatory issues, for example in relation to approval of the annual Availability of Resources certificate. Whilst that might reinforce the link between a SID's duties and the particular interests of the licensee, we believe it could undermine the unity of the NWO board which would be undesirable.

4.13. Under our proposals the selection and appointment of SIDs would be a matter for NWOs and their owners, subject only to the criteria in the licence condition. We would not have a role in interviewing candidates or approving appointments.

Costs of the proposal

4.14. We consider there are two areas of cost associated with our proposal:

- (iii). Notwithstanding our view that the proposal should not significantly impinge on the ability of NWO owners to exert proper influence, we acknowledge that they would be obliged to appoint two non-executive directors who they might not otherwise choose.
- (iv). There would be a financial cost involved in the recruitment, retention and logistical support of suitable appointees and in facilitating their participation in board meetings of the NWO.

4.15. We believe that these costs are proportionate and warranted in light of the objectives of our proposal. We envisage that efficiently incurred costs under point (ii) above would be admitted under the business support costs category of price control allowances for NWOs. Levels of remuneration would be a matter for NWOs, but in general terms we would expect them to be at (but not higher than) the level necessary to appoint and retain suitable candidates. This is consistent with the guidance on directors' remuneration in the UK Corporate Governance Code¹⁴. Similarly, matters of selection and the terms of service contracts would be for NWOs and their owners to decide.

¹⁴ <http://www.frc.org.uk/corporate/ukcgcode.cfm>

4.16. Some respondents suggested that there might be a shortage of suitable candidates for appointment and that this in itself could add to costs. However, we feel that our updated criteria for sufficient independence should open up a relatively wide field of eligibility. In particular, experienced retirees from energy industry management may prove to be one source of candidates although SIDs could come from a number of different backgrounds. We understand that water undertakers have not experienced serious difficulty in sourcing board appointees in relation to the licence requirement applicable to most licensees that the composition of their boards should be such that the directors can act independently of the parent company or controlling shareholder and exclusively in the interests of the appointee.

Responses to earlier consultation

4.17. NWOs and business owners who responded to our earlier consultation raised a number of pertinent queries and concerns in relation to our original proposals. An overriding concern was that our proposals for a majority of independent directors was disproportionate in relation to the risks referred to and would impact on the legitimate ability of shareholders to influence and direct the management of NWOs and might even impact on decisions to take on or retain ownership. The point was made that groups should be able to run network businesses as wholly owned subsidiaries and efficiently combine the management of two or more NWOs within a group.

4.18. As set out above, it is not our intention to interfere with proper influence and control over NWO businesses by their owners and in response to concerns which have been expressed we have changed our proposals so that they would now require NWOs to have two sufficiently independent directors. This means that that they need not be in a majority on the NWO board. We have also made clear that the SIDs would have no special regulatory responsibilities and that, subject to the criteria in the draft condition, their selection and appointment would be a matter for the business and its owners.

4.19. A number of other queries and issues were raised by various NWO respondents which we have summarised with our comments at Appendix 4. It is relevant to note that one finance provider who commented on our initial proposals relating to independent directors viewed them as a positive measure. We would be interested to receive comments and feedback from finance providers and other stakeholders on our updated proposals.

Consistency with Ofgem's duties and legislative provisions

4.20. We consider that it is legitimate for us to propose a requirement for sufficiently independent directors on the boards of licensees. Our proposals relate to a concern that there should be non executive representation on NWO boards which can provide an un-conflicted perspective on the NWO's interests, including in relation to licence compliance, in all circumstances. The presence and influence of independent non-executives at group level in some cases, whilst beneficial, does not address the particular risks and potential benefits which we have identified.

4.21. We also take the view that there would be no inherent conflict between the role of a sufficiently independent director appointed under a regulatory requirement and the duties imposed on all company directors by companies legislation. We consider that this would hold true even if SIDs had particular responsibilities in relation to licence compliance although, as explained above, we have decided not to propose such

an approach. Some respondents commented that where an NWO is a wholly owned subsidiary, a director's duty is to act in the best interests of the owner. However, it is relevant to note the provisions of section 172 of the Companies Act 2006 which says that:

*A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to—
.....
(f) the need to act fairly as between members of the company.*

4.22. In light of these we consider that the duty of a director is to act in the best interests of the company and to promote its success. We believe that the words "for the benefit of its members as a whole" reflect the obligation established in any case by the unfair prejudice provisions in companies legislation which say that directors should not to act to benefit one group of members at the expense of another¹⁵. Consequently, we consider that if there is a conflict between the best interests of the company (in this case the NWO) and the best interests of its shareholder, we believe a director of the NWO has a duty to prefer the interests of the NWO.

4.23. This inevitably gives rise to the potential for tension in some instances where an individual is a director of both the NWO and one or more affiliated companies, since they would owe duties to each of those companies which could be in conflict. Compliance with the ring fence conditions and with licence conditions generally are almost certainly intrinsic to promoting the interests of an NWO. However, an NWO may also be dependent to some extent on relationships with its parent company and/or affiliates. In many corporate scenarios, latent tensions of this kind are perfectly manageable and there are mechanisms (chiefly relating to disclosure) to manage conflicts when they do arise. However, the ring fence provisions are intended to address the special position of NWOs and to be effective in all circumstances including those of financial distress.

Effectiveness of sanctions in relation to directors' conduct

4.24. A number of respondents pointed out that directors' conduct is covered by a range of sanctions provided for in company law, insolvency law, regulations and general criminal law, meaning that individuals are bound to take their responsibilities very seriously. Breaches of these laws could give rise to fines, disqualification or even imprisonment.

4.25. We consider that a director is likely to be deterred by the prospect of a penalty but the deterrent effect is weakened if he or she is not aware or does not realise that actions they are taking are wrong. Whilst in some cases this might be obvious, such as in the making of a false return, the conflict of interest circumstances we have referred to above are much less clear cut. We consider that there is a risk that a conflicted director might well act with the best of intentions in the face of a crisis situation but not consider that he or she is doing anything wrong with regard to particular licence compliance issues because of a lack of focus on or reminder of specific obligations applicable to the NWO as a licence holder which become relevant in the particular circumstances. In our view, a sufficiently independent director is more

¹⁵ Section 994 of the Companies Act 2006

likely to remain focussed on those requirements and remind others of relevant requirements when issues are being discussed at board level in critical situations and should therefore be in a position to provide the voice of reason previously referred to. This in turn would tend to engage the deterrent effect of the sanctions regime because subsequent board decisions would have been taken in light of concerns which had been raised.

CEPA report to Ofgem – October 2009

4.26. Some respondents to our initial consultation drew attention to comments made by our consultants, Cambridge Economic Policy Associates Ltd (CEPA) at section 7.6 of their report to us dated October 2009 (see associated document b). Referring to the existing requirement in Water Undertaking licences they expressed some doubts that that additional non-executive board members would be likely to have a significant impact.

4.27. CEPA commented that:

- additional independent directors would still be appointed by the NWO's parent company which could subsequently remove them, and
- independent directors would have the same duties as other directors under companies legislation.

4.28. CEPA also referred to the possibility of strengthening the independence of NWOs through governance requirements of the type referred to in the third package of EU Directives on energy markets in relation to the control that a vertically integrated undertaking can exercise on a transmission system operator. For example, there is a requirement at paragraph 1(a) of Article 18 of the Directives for a transmission system operator to have effective decision making rights, independent from the vertically integrated undertaking, with respect to assets necessary to operate, maintain or develop the transmission system.

4.29. We acknowledge these points which were made in the context of our initial consideration of a requirement for a majority of independent directors. As outlined in this chapter, our developed proposal for two sufficiently independent directors seeks to address these aspects.

Offshore transmission owners and independent distribution network operators

4.30. We propose that the requirement for sufficiently independent directors should not apply to offshore transmission owners (OFTOs) nor to independent distribution network operators (IGTs and IDNOs). These NWOs, although protected energy companies, have very different risk profiles from the large onshore network operators (which we expand on below) and this means that the cost/benefit arguments in relation to sufficiently independent directors are also significantly altered. Given the possibility that, in future, there may be proposals for some major energy suppliers to be classed as protected energy companies, it is relevant to note that we do not see a direct link between protected energy company status and a requirement for SIDs.

OFTOs

4.31. Each OFTO will only own and operate one offshore transmission network (although there could be more than one OFTO within a corporate group). OFTOs are

generally set up as special purpose vehicles (SPVs) and subject to project financing which is generally covenant-heavy. Notwithstanding our comments in paragraph 3.55 (covenants protect the interests of lenders), this aspect means that the corporate structures of OFTOs are likely to be significantly different from those of the incumbent onshore network operators. OFTO networks will also have a simpler configuration than onshore electricity transmission or distribution networks since they basically consist of one or more extra high voltage cables between an offshore substation platform and an onshore substation (as opposed to a more complex system of connections) and OFTO networks do not provide direct connections to electricity consumers. An OFTO's logistical and administrative requirements are therefore much less complex than those needed by a large onshore network operator. It is also relevant to note that OFTO licences include 'OFTO of last resort' provisions which do not appear in other types of NWO licence.

IGTs and IDNOs

4.32. IGTs and IDNOs vary in size, but all are significantly smaller businesses than the incumbent transmission and distribution network operators and the impact of a financial distress event would be commensurately lower. The table below provides some information on recent turnover levels to give some idea of this size differential.

Table 4.1 – NWO turnover levels¹⁶

£m	GDN ¹⁷	DNO	Independent network operators	
			IGT	IDNO
Highest	540	474	37	2
Lowest	243	124	0.1	0.1

4.33. The costs of recruiting and retaining sufficiently independent directors would be likely to be broadly the same in absolute terms for IGTs and IDNOs as they would be for the larger, incumbent network operators, but relative to the size of their businesses they would be much higher. We also note that 'inset' water licensees are not presently subject to licence requirements relating to board independence.

4.34. In light of the factors referred to above, we do not think a requirement for sufficiently independent directors would be proportionate in the case of OFTOs, IGTs or IDNOs and we consider that treating these NWOs differently in this regard would be objectively justified.

¹⁶ Per accounts filed at Companies House

¹⁷ Figures in this column relate to the non-National Grid GDNs

Possible alternative approaches

4.35. Our view is that the proposal for two sufficiently independent directors set out above is the best way to manage the risks and achieve the benefits which we have described. We also consider that our updated proposals address the concerns which respondents raised in relation to the possible requirement for a majority of independent directors which was suggested in our initial consultation and impact assessment last year. We think our proposals are proportionate, given the need to promote good governance at NWO level and to address the risks associated with potential conflicts of interest at times of financial distress, even though the likelihood of financial distress arising is small. However, in response to our circulation of early draft licence conditions in October 2010 two respondents suggested alternative approaches ('the SID alternatives').

Independent auditor report on pre-dividend certificate

4.36. One NWO suggested that if a primary concern is that the owners of an NWO could cause a dividend to be inappropriately paid at a time of financial distress then the NWO's pre-dividend certificate of adequate financial resources could be made subject to a report by the NWO's independent auditor. If that report were to be adverse, Ofgem could prohibit payment of the dividend.

4.37. This would involve the drafting of procedures for the auditor to follow in making a report, possibly involving a review of cash flow projections, budgets and business plans as well as discussions with business managers. We have not yet discussed the feasibility of such a review with audit firms but we consider it likely that auditors would only be willing to report factual findings against agreed procedures which might limit the value of the process.

4.38. Whilst the possibility of an inappropriate dividend payment is a concern we have identified, it is only one of the issues that could arise if the NWO's directors were conflicted in the way we have referred to in the preceding sections of this chapter. The suggested measure would impose an additional regulatory requirement on NWOs but it would only address one particular risk. It would not, for example address the risk that inappropriate loans or asset transfers could be made in similar circumstances. In addition it would not achieve the enhancement to corporate governance at NWO level which we think a requirement for SIDs would. The NWO board might need to consider a wide range of situations both in normal times and at times of exigency and SIDs would be able to make a valuable contribution in that regard.

4.39. We also consider that this is an example of a more interventionist regulatory measure of the type we referred to in our initial consultation document (see chapter 4 of associated document a). Whilst we considered that a range of such measures might be effective in managing risk, we identified some significant drawbacks with this approach:

- there would be a significantly higher regulatory burden on NWOs potentially imposing additional costs which would be borne by consumers,
- additional regulatory scrutiny would be required which might divert our attention from other important issues, and

- NWOs might consider themselves absolved of some responsibility for risk control if they were following a set of detailed compliance rules.

4.40. In addition, the possibility of more interventionist measures, especially those involving mechanisms at the discretion of Ofgem proved unpopular with the majority of respondents to our initial consultation.

Corporate governance assurance at group level

4.41. The second broad alternative approach to our proposals would be to place greater reliance on corporate governance regimes at group level, recognising the supervisory role that a parent company has over the whole of a group business. This would involve working with owners and managers to understand group governance approaches and their coverage of NWOs including licence compliance issues. This could include, for example, the role of independent directors on listed parent boards (where applicable), board committees and internal and external audit functions. It might also involve encouraging or requiring NWOs to arrange governance training for their directors.

4.42. On this theme, one respondent to our earlier consultations suggested that NWOs who are members of groups headed by a listed company should be exempt from the requirement for SIDs. The basis for this view is that the NWO benefits from the halo effect of corporate governance requirements set out in listing rules and the UK Corporate Governance Code.

4.43. We do attach considerable importance to the influence of good governance at group level on NWO businesses. Indeed, we have acknowledged in this paper that primary responsibility for the financial and operational health of network businesses lies with owners and managers and that, in practical terms, much of the necessary organisation and work takes place at business unit or group levels. However, we consider that there are two broad benefits which a requirement for sufficiently independent directors would bring and which would not be engendered by effective group governance:

- assertion of the identity of the NWO as a protected energy company notwithstanding its inter-relationships with other entities within a wider business, and
- an unconflicted voice of reason with respect to the interests of the licensed NWO business at times of operational or financial stress

Views and opinions requested

4.44. We would be interested to receive views and opinions on the alternative approaches referred to above in the context of our proposed licence condition. We would be especially interested to receive comments on how effective a requirement for SIDs (or the alternative approaches referred to) would be in promoting good corporate governance at NWO level and helping to address the types of compliance issue which have given rise to recent Ofgem investigations¹⁸.

¹⁸ Details of open and closed investigations can be found on the Ofgem website: <http://www.ofgem.gov.uk/About%20us/enforcement/Investigations/Pages/Invstigations.aspx>

4.45. We would also be pleased to receive views on whether additional external audit requirements (of the type referred to in paragraphs 4.36 to 4.37) could be useful measures.

5. Impacts, costs and benefits

Requirement for the Authority to consider the impact of its proposals

5.1. We are keen to obtain feedback from stakeholders on the proposals in this paper.

5.2. In considering and consulting on the impact of proposals the Authority is obliged to have regard to a number of key issues (outlined below) in the context of relevant legislation and official guidelines which include:

- The Gas Act 1986
- The Electricity Act 1989
- The Utilities Act 2000
- The Energy Act 2004
- Directive 2009/72/EC concerning common rules for the internal market in electricity
- Directive 2009/73/EC concerning common rules for the internal market in natural gas
- Social and Environmental Guidance to the Gas and Electricity Markets Authority issued by the Secretary of State (including published draft guidance)

Impact on consumers

5.3. We do not consider that our package of proposals would have an immediate or direct impact on consumers.

5.4. Network operators would be allowed to recover the efficient additional costs of complying with any new requirements through their charges but the net financial impact should be minimal. We estimate that it would represent less than 0.1% of a customer's gas or electricity bill and in the longer term these costs might be offset by savings from better corporate governance and reduced costs of capital.

5.5. Over time, consumers should benefit from enhancements to the financial stability and governance of NWOs resulting from the proposed changes in several ways:

- the risk that customer service levels and network development could be compromised by financial distress should be reduced,
- flexibility in terms of the ownership, financing and management of networks should be enhanced supporting innovation and efficiency,
- the risk of customers having to bear costs associated with a price control reopener or special administration process will be minimised.

5.6. In addition, consumers, energy retailers and other stakeholders should derive more general benefits from the improved governance at NWO level which our proposals are intended to promote.

5.7. The main financial cost of our proposals would relate to a requirement for NWOs to appoint and support the work of two sufficiently independent directors. In this

context we have considered what the cost implications of the SID alternatives (see paragraphs 4.35 to 4.43 in chapter 4).

5.8. We consider that a requirement to obtain an independent auditor's report on pre-dividend certificates would involve financial costs, although again these would not be material set against the overall costs of network investment and operation. If, however, the requirement was developed as part of a wider package of regulatory checks and controls, the costs which would be passed through to consumers might be more material.

5.9. There would be fewer identifiable financial costs associated with the promotion of good governance within corporate groups, but if particular initiatives were taken forward that position could change.

Proportionality of proposals

5.10. Gas and electricity transmission and distribution networks form a vital part of our national infrastructure. Even though the existing ring fence conditions have worked satisfactorily to date, we consider it is right to address serious new risks which have developed since their introduction, especially in light of the global liquidity crisis which emerged in 2008.

5.11. In our earlier consultation we referred to alternative ways forward which would have involved proposals for either much more, or much less regulatory intervention. However, we do not believe that either of these approaches would achieve the required objectives. We have therefore developed what we consider to be a focussed package of improvements to the ring fence conditions so that they continue to be effective as both preventative and remedial mechanisms for years to come. We also consider that our proposals will enhance the synergic nature of the ring fence as a whole. However, we have sought to avoid unnecessary changes and to that end we are making no proposals in respect of two of the existing conditions.

5.12. We have significantly updated our proposals in light of responses to our initial consultation/impact assessment, the industry workshop we held and other feedback. For example, we have made the following changes to our initial proposals:

- we have confirmed that an annual board certification of operational/business resources would not be subject to an independent auditor's report because we accept that this might be difficult and/or costly to obtain for limited additional benefit, and
- we are not proposing that ultimate controller undertakings should be novated periodically because of the problems this could entail where NWOs are owned by overseas corporations or infrastructure funds.

5.13. In particular, we have acknowledged that a requirement relating to independent directors is contentious. We have made significant changes to our initial proposals to minimise the possible impact on legitimate influence and control by business owners and to avoid any interference with the unitary nature of NWO boards. We have also provided information on two alternative ways forward which have been suggested and invited feedback and comments on these.

5.14. Whilst maintaining the broad uniformity of the ring fence, we have tailored our proposals to acknowledge the different situations of smaller independent network operators and offshore transmission operators who will be subject to different financing arrangements. We have also ensured that our proposals are in harmony with the new RIIO framework for the economic regulation of energy networks.

5.15. We have preserved the existing consent mechanisms in the conditions to allow regulatory flexibility in exceptional circumstances and, whilst the new requirements should prompt regular governance reviews by NWOs, most restrictions would only bite as preventative measures at times of financial pressure when we would expect the NWO to be in discussion with us in any case.

5.16. We do not think that the additional administrative work implied by our proposals would be unduly onerous, but we will consider feedback from stakeholders in this regard. Overall, we believe that the package set out in this paper represents a proportionate response to the changing business and financing environment for network operators in Great Britain. In particular we consider that our proposals address the risks which came to light following the global liquidity crisis of 2007/08 and the ensuing economic downturn. The regulatory ring fence arrangements for NWOs have served well since their introduction during the 1990s and this review should ensure that they remain fit for purpose for the years to come.

Competition and markets / security and reliability of energy supplies and investment in energy networks

5.17. Although energy networks, once established, are natural monopolies, the emergence of independent operators means that developers now have a degree of choice with regard to the provision of local infrastructure. In addition, offshore transmission licences are now granted on the basis of a competitive tender process.

5.18. In framing our proposals we have considered whether requirements should be varied to reflect the different business models and regulatory treatments which apply to these types of NWO. As a result of this process we are proposing that:

- OFTOs should not be subject to the proposed restriction on the granting of charges over receivables (see paragraph 3.13), and
- IGTs and IDNOs should not be subject to the proposed requirement for sufficiently independent directors (see paragraph 4.2).

5.19. In making our proposals we have stressed that primary responsibility for the efficient management of network businesses lies with their owners and boards. We consider that by promoting financial stability and good governance our proposals will allow liquidity and flexibility in the ownership and management of NWO businesses. This in turn should support the ability of NWOs to access equity and debt markets for their financing needs at reasonable costs. Access to reliable, financially stable networks is also important to the ongoing development of competition in energy retail markets.

Consistency with the approach of other regulators

5.20. Although regulatory regimes are bound to vary to some extent in line with the characteristics of different industries, we would expect principles relating to the promotion of financial and operational stability to be generally applicable.

5.21. We view our proposals as being compatible with the approach of other regulators in the utilities, transport and financial sectors. We also consider they are in line with the proposed principles for economic regulation set out in the call for evidence document recently published by the Department for Business Innovation and Skills¹⁹.

Sustainable development

5.22. This covers five important areas:

- Managing the transition to a low carbon economy
- Eradicating fuel poverty and protecting vulnerable consumers
- Promoting energy savings
- Ensuring a secure and reliable gas and electricity supply
- Supporting improved environmental performance

5.23. We don't consider our proposals would have any direct impact on sustainable development. However, our proposals should further improve the licence conditions designed to ensure that NWOs always have the resources necessary to meet their commitments under legislation and their licences. This resourcing would include the investment necessary to fulfil sustainable development initiatives.

Health and safety

5.24. We do not believe that our proposals will have any direct impact in this area. However, there should be some indirect benefits. For example, the requirement for NWOs to maintain an intervention plan should be positive because, in a contingency situation, it would provide management with high level information on operational factors relevant to the licensee, such as maintenance contracts.

Risks and unintended consequences

5.25. Risks associated with our proposals include the possibility that:

- they may not bring about the benefits we have set out,
- stakeholders could perceive an increased possibility that an NWO could be subject to an insolvency process,
- business elements might be artificially moved outside the licensee ring fence, for example, to avoid the enhanced 'lock up' provision,
- business elements might be artificially brought inside the licensee ring fence if thought necessary to facilitate resourcing certification,

¹⁹ <http://www.bis.gov.uk/assets/biscore/better-regulation/docs/p/11-519-principles-economic-regulation-call-for-evidence.pdf>

- changes might impact disproportionately on some NWOs because of their size or legacy arrangements which they have in place,
- extensions to the cash lock up trigger and prohibition on granting charges over receivables could 'interfere' with financing arrangements, and
- a requirement for sufficiently independent directors might discourage some parties from taking ownership stakes in NWOs when the SID alternatives suggested (see paragraphs 4.35 to 4.42) might avoid this risk.

Other impacts, costs and benefits

5.26. We acknowledge that our preferred approach will impose some additional costs on licensees, for example in respect of service contracts for new, sufficiently independent directors. Efficient additional costs would be funded through price controls and would consequently be passed on to energy consumers. However, as mentioned in paragraph 5.4 above, we consider it unlikely that these costs would be material and they should be outweighed by the benefits of the improved ring fence. It is relevant to say that the efficient costs of other options suggested by respondent could also be funded through price control allowances if adopted.

5.27. We have sought to draft proposed licence conditions (see separate appendices document) which are clear and unambiguous to minimise unnecessary compliance effort. We will consider any improvements to drafting which are suggested by respondents to this consultation. We have also avoided proposing retroactive measures which could undermine regulatory certainty.

Post-implementation review

5.28. We expect to conduct a post-implementation review at an appropriate time, after the introduction of any licence modifications.

Conclusion

5.29. We consider that our proposed modifications to the ring fence conditions in NWO licences will bring worthwhile benefits to consumers over time. However, most of these benefits will be indirect because our proposals would introduce measures which are preventative in nature and primarily address financial risks which have developed since the ring fence conditions were introduced more than ten years ago. These include factors which emerged from the recent global liquidity crisis. However, we believe that an improved ring fence will also support diversity in the ownership, financing and management of network businesses and consequently promote efficiency. In our view the risks associated with our proposals are limited and manageable.

5.30. Although the implementation of our proposals would involve some additional costs, we consider that the impact on consumers' energy bills should be minimal. We are proposing the minimum level of changes we consider necessary and we have tried to keep our drafting as straightforward as possible to minimise the compliance effort which they would involve. We have provided information on the responses received to our earlier consultations and explained how we have adapted our proposals in light of

these. In particular we have set out the suggested alternatives to a possible requirement for sufficiently independent directors on NWO boards.

5.31. We acknowledge that our proposed requirement for most NWOs to have two sufficiently independent directors (SIDs) on their boards will prove contentious and we have aired the alternatives which have been put forward for debate (see chapter 4). In particular we have asked for feedback on suggestions that:

- pre-dividend certificates could be subject to a report by an independent auditor, and
- NWOs with a UK listed parent company should not be subject to the proposed requirement for SIDs because they benefit from corporate governance regimes and the influence of non-executive independent directors at group level.

5.32. We have taken account of the responses we received to our earlier consultations on the ring fence and we will similarly take full account of responses to this consultation.

6. Next steps

Responding to this consultation

6.1. This document sets out the changes we think should be made to the ring fence conditions in network licenses.

6.2. We have shown the possible changes to existing licence conditions in a separate appendices document (associated document 1) and we would welcome views from all interested stakeholders on both our policy intent and the detailed illustrative drafting. With regard to our proposed requirement for sufficiently independent directors we would be interested in feedback on the alternative approaches which have been suggested and which we have referred to in chapter 4.

6.3. We will carefully consider all the responses we receive to this consultation by the deadline date of 30 June 2011. Without prejudice to this process, we hope to progress to decisions without undue delay, so that identified risks can be addressed and the benefits of enhanced ring fence conditions obtained as soon as possible. Subject to this consultation, we therefore hope to be in a position to publish a decision letter and give formal notice of proposed licence modifications by September 2011.

6.4. The legislative provisions relating to the modification of standard conditions of network licences are contained in sections 23 and 11A of the Gas Act 1986 and the Electricity Act 1989 respectively. It is relevant to note that these provisions are expected to be amended via regulations made by the Secretary of State approved by Parliament during 2011 so that they are consistent with requirements under the internal markets Directives referred to at paragraph 5.2 in the preceding chapter. Further information on this can be obtained in DECC's publication: Implementation of the EU Third Internal Energy Package - Government Response²⁰.

6.5. Details of the process for responding to this consultation are given in Appendix 1.

²⁰ <http://www.decc.gov.uk/assets/decc/Consultations/eu-third-package/1163-eu-third-package-gov-response.pdf>

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Appendix 1 - Consultation responses and questions

1.1. Ofgem would like to hear the views of interested parties in relation to any of the issues set out in this document. In particular, we would like to hear from network operators, finance providers, energy suppliers and consumer representatives. Please give reasons for your views with reference to this consultation document, or other material which you would like us to consider.

1.2. We would especially welcome responses to the specific questions which we have set out at the beginning of each chapter heading and which are replicated in Appendix 5 below.

1.3. Responses should be received by 30 June 2011 and should be sent for the attention of:

Paul Darby

Regulatory Finance Team
Ofgem, 9 Millbank, London, SW1P 3GE.

020 7901 7072

regulatoryfinance@ofgem.gov.uk

1.4. Unless marked confidential, all responses will be published by placing them in the Ofgem library and on our website www.ofgem.gov.uk. Respondents may request that their response is kept confidential. We will respect this request, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

1.5. Respondents who wish to have their responses remain confidential should clearly mark the document/s to that effect and include the reasons for confidentiality. It would be helpful if responses could be submitted electronically to the email address above where possible. Respondents are asked to put any confidential material in the appendices to their responses.

1.6. Any questions on this document should, in the first instance, be directed to:

Paul Darby

Regulatory Finance Team
Ofgem, 9 Millbank, London, SW1P 3GE.

020 7901 7072

paul.darby@ofgem.gov.uk

Appendix 2 – Background to our proposals

1.1. All of the NWOs in Great Britain are part of corporate groups, some of them large groups with overseas ownership interests. In many cases, financial, administrative and operational resources, including those for the NWO, are managed at group level and the flexibility to do this has been beneficial to network users and consumers. There have also been some significant corporate transactions affecting NWOs recently and although many remain part of energy industry groups, some are now owned by international infrastructure funds.

1.2. The commercial reality of such business arrangements and developments are of course important and we do pay attention to financial issues, such as gearing, at group and ownership levels. However, our regulatory focus, in terms of financial stability and financeability, must centre on the licensed network operators. It is these companies which own the network infrastructure, are entitled to collect regulated revenues and are subject to particular legal requirements and regulation under their licenses. In particular, NWOs have the status of Protected Energy Companies under section 154 of the Energy Act 2004.

The regulatory ring fence

1.3. The regulatory ring fence presently consists of six licence conditions which feature in all types of network operator licence, although the wording and format varies to some extent. The conditions cover:

- restrictions on the disposal of network assets (or the granting of security over them),
- restrictions on the type of business and investment activity the licensee can engage in,
- the availability of resources,
- undertakings from ultimate controllers,
- credit rating requirements, and
- restrictions on indebtedness and transactions with affiliates.

1.4. The main purpose of the ring fence is to ensure that the infrastructure and resources required by NWOs and financed by consumers through their energy bills, are properly conserved and protected from adverse financial factors which might be affecting the NWOs' ownership groups or the wider economy. To this end, the ring fence conditions stipulate things which the NWO must either do or, as the case may be, not do. They contribute to a defence in depth and breadth to the risk that an NWO could be affected by financial or operational distress.

1.5. In December 2008, in light of the global liquidity crisis, we published a position paper setting out our intention to develop a guidance document covering the arrangements we have in place to deal with financial distress scenarios (see associated document g). In March 2009 we carried out 'war game' exercises to test our arrangements which we followed up with a consultation publication in May 2009 (see

associated document h). In October 2009, we published a decision document and our finalised guidance document on arrangements for responding to financial distress in an NWO (see associated document i).

1.6. We have also developed our approach to monitoring the financial stability of NWO groups and updated the information which we collect, wherever possible through existing reporting requirements. For example, we now collect information on cash flow projections and finance maturity schedules in regulatory reporting packs.

Defence in depth

1.7. As mentioned above, the price controls we set are designed to ensure that efficient NWOs can earn a fair return after efficient investment and operating costs. This should enable them to comply with all of the ring fence requirements. However, if requirements are breached, regulatory review or intervention would be triggered together with additional restrictions under some of the conditions. This should mean that there is early warning of problems allowing them to be resolved or alleviated, and potentially avoiding the need for special administration arrangements. Remedial action in such circumstances might be taken forward by the owners or managers of the business, possibly in conjunction with finance providers.

1.8. Exceptionally, the ring fence measures could help to facilitate a price control re-opening process²¹. We would not re-open the terms of a price control to 'bail out' a company suffering financial distress because of poor management or inefficiency. However, there could be circumstances where a well managed, efficient company faced significantly higher costs in carrying out its activities which could not be avoided and which could not have been anticipated in its price control arrangements. We are referring here to a fundamental change to the factors on which price control assumptions were based – NWOs, as commercial companies, are properly exposed to a certain level of price risk in terms of their costs and profitability.

1.9. In extremis, the ring fence provisions should also improve the circumstances of any energy administration process because, for example:

- network assets would be owned by the NWO, unencumbered by security interests (because of the restrictions on disposing of or granting charges over network assets) ,
- the affairs of the network business should not be complicated by extraneous activities (because of the restriction on these activities),
- liquidity insolvency scenarios are more likely to be resolvable through restructuring (because of the regard that management should have had to medium to long term financing requirements), and
- the cash lock up should have prevented inappropriate payments or asset transfers to affiliates.

²¹ In this context we are referring to a fundamental reassessment of allowed revenues rather than an anticipated adjustment or the operation of an uncertainty mechanism.

1.10. Given this context, when we consider amendments to the financial ring fence, it can be useful to review their effectiveness in the circumstances of a hypothetical financial distress or energy administration scenario. However, it should be stressed that none of the proposals in this document mean that we view the re-opening of a price control or a special administration process as expedient measures other than in exceptional circumstances. On the contrary, we consider that our proposed changes to the ring fence will make them significantly less likely to occur.

Defence in breadth

1.11. The ring fence conditions are synergic to some extent and most of the restrictions in them are additive. For example, restrictions on the types of payments and transfers which an NWO can make to related parties work hand in hand with the requirement for the NWO to ensure that it always has the financial and operational resources needed to carry on its regulated activities. Our proposals are intended to enhance this synergic effect.

Licence enforcement and sanctions for non-compliance

1.12. Where we become aware of a licence condition being breached we can take enforcement action to rectify the breach and/or to penalise the NWO for the non-compliant behaviour. This action might range from imposing arrangements to remedy minor breaches through to the formal investigation of more serious matters and the issuing of penalties as appropriate. Our published Enforcement Guidelines²² provide information on our approach to the investigation of licence breaches. They also refer to the process for appeals to the Court against enforcement decisions.

1.13. Licence compliance issues may come to our attention because of complaints, regulatory review work, or because matters have been identified through the internal governance procedures undertaken by NWOs themselves or their corporate groups. Ofgem's regulatory powers generally relate to NWOs, the companies holding licences - and not to other companies, the parent company or individuals. However, the Gas Act 1986 and Electricity Act 1989 do confer the power to require individuals to provide documentation and (if carrying on business) information under some circumstances²³. In addition, in some regards, such as under ultimate controller undertakings (see chapter 3), the NWO can be directed by Ofgem to enforce its own rights against third parties. In addition, if appropriate, we can refer matters of wrongdoing or misconduct which are not covered by our regulatory powers to other relevant authorities for review.

1.14. In reality, regulatory influence is more pervasive since many aspects of NWO operations, financing and compliance matters are managed within wider group functions. In addition, financial penalties impact on NWO shareholders and this will usually mean the parent group and its own shareholders.

²² <http://www.ofgem.gov.uk/About%20us/enforcement/Documents1/Enforcement%20Guidelines%20post%20consultation.pdf>

²³ Section 38 of the Gas Act 1986 and section 28 of the Electricity Act 1989.

1.15. In our drafting of the proposed conditions we have incorporated some significant changes to our original proposals to take into account, as far as possible, the comments and concerns which have been raised by NWOs, whilst still addressing the regulatory objectives. In October 2010 we circulated an early draft of revised conditions (for the electricity distribution licence only at that stage) to illustrate the approach we would be taking. We also invited further feedback which could be taken into account in formulating our proposals.

1.16. Following our initial consultation and industry workshop (see Chapter 3) the Authority considered a revised set of recommended changes to the ring fence at its meeting in Glasgow in September 2010 and decided that we should consult on the revised modification proposals set out in this document.

Appendix 3 – Summary of changes to existing ring fence conditions

1.1. The bullet points in this appendix represent a high level summary of the existing ring fence conditions and proposed changes. Reference should be made to the licences themselves for the full text of existing conditions.

1.2. Red text indicates the changes proposed in our Impact Assessment document dated 3 March 2010 (see Associated Document a.) and blue text/strike-through shows the revisions made for our current proposals.

Disposal of Relevant Assets

Unless Authority consents (possibly with conditions)²⁴

- No disposal of / granting of security over / relinquishment of control over:
 - Elements of the energy network/control centres (and land rights)
 - Several categories of exempt disposals up to £200k in value
 - Resource provider can take operational control (conditions and undertakings apply)
 - No granting of security over receivables (being a contractual right of the licensee to receive cash or another financial asset from another entity)

Restriction of activity and financial ring fencing

Must not carry on activity other than network business

- Can have up to 2.5% de 'minimis' activity (or more with consent)
- Can only hold shares for the purpose of the network business or financing

Availability of resources

Licensee must always have sufficient financial and other resources to carry on network business

- Certificate to Authority by 31 July annually – sufficient financial resources for next 12 months

Certificate also to cover operational resources and confirm compliance with key licence conditions (per existing pre-dividend certificate):

- Availability of (all necessary) resources
- Provision of information to the Authority

²⁴ Consent by default if Authority does not respond within two months; disposal of significant part of GB gas system requires consent of Secretary of State

- Restriction of activity and financial ring-fencing
- Undertaking from ultimate controller
- Credit rating of the licensee
- Restriction of indebtedness and transfer of funds
- Statement of factors taken into account [only in respect of availability of resources]
- Auditors to confirm not inconsistent with work on last regulatory accounts [only in respect of availability of financial resources]
- Requirement to report change in circumstances/basis for expectations as soon as it arises
- Certificate to Authority before payment of a dividend – compliant with key licence conditions (inc availability of resources) – valid for 6 months
- Requirement to maintain an intervention plan ~~‘living will’~~ record of key financial and contractual arrangements - can consist of references to existing documentation

Ultimate controller undertaking

- Legally enforceable deed from ultimate controller(s) – copied to Authority
 - refrain from action likely to cause breach by licensee
 - impose same requirement on its other subsidiaries
- Provide annual schedule of extant undertakings and confirm that ultimate controllers have been re-apprised of their responsibilities under the deeds
- Comply with direction by Authority to enforce terms
- Report any breach of undertaking to Authority

Credit rating of the licensee

- Must maintain investment grade credit rating (long term/senior debt)
- Independent distributors have ‘alternative arrangements’
 - Keepwell with parent
 - 6 months cash in escrow/on-demand bond

Restriction of indebtedness

Unless Authority consents:

- No indebtedness or granting of security except on normal commercial terms and for the purpose of the network business
- No payments or transfers to related parties except:
 - lawful dividend
 - lawful repayment of capital
 - payments for goods and services
 - market rate loans to related parties with investment grade credit ratings
 - repayment of loans
 - payments for group tax relief
 - acquisition of shares (for the purpose of the business or financing)
- Cash lock up if licensee loses investment grade (or on warning for downgrade)
- Or if licensee makes adverse annual availability or resources certificate or any report of adversely changed adequacy of resources status
- Or if licensee breaches any banking or other financing covenants (unless pre-cleared by Authority) ~~or enters into an arrangement to alter the terms of any such arrangements to avoid a breach:~~
 - No payments to related parties except:
 - payments due for goods and services where commitment entered into before lock up
 - transfers/loans where consideration received at same time
 - loan/interest payments when due provided arrangement entered into before lock-up
 - payment for group tax relief not before tax due date
 - No new/renewed cross default obligations
- Release from cash lock up upon:
 - confirmation that licensee has regained covenant-compliant status (including through renegotiation) and notified the position to the Authority, or as appropriate
 - fresh certification of availability of financial and all other required resources and compliance with other conditions referred to in annual certification requirement

Board composition

- At least two ~~Majority of independent~~ sufficiently independent ~~directors of licensee~~ (sufficiency of independence indicators given in licence condition):
 - Resignation or removal of sufficiently independent directors to be reported to the Authority within 14 days, with a statement of the reasons, and new appointment(s) to be made as soon as practicably possible

Appendix 4 – Feedback on initial proposal relating to independent directors and Ofgem comments

1.1. A number of queries and comments were raised by various NWO respondents in relation to our initial proposals for an independent directors requirement which we have summarised below, in each case followed by our comments (see also chapter 4).

- (i) *A key reason for the appointment of independent directors in listed companies is to safeguard against conflicts of interest between managers and owners, but this conflict wouldn't arise for NWOs.*

We have referred to the possibility that NWO directors who also have board appointments or executive responsibilities with parent/affiliate companies could face an unresolvable conflict of interest in extreme circumstances.

- (ii) *Are Sufficiently Independent Directors (SIDs) intended to safeguard an NWO's independence from affiliate energy producers or retailers?*

This is not a main reason for our proposal; requirements for business separation are addressed by other licence conditions. However, as mentioned at paragraph 10 of chapter 4, we believe our proposals will be consistent with references to independence requirements in the third package of EU Directives on energy markets.

- (iii) *Independent directors might be less likely to act decisively in a crisis situation because they have no 'skin in the game'.*

SIDs would bring an unconflicted/detached view to NWO board discussions in a financial distress scenario. Together with input from the executives, this would allow the board to reach informed and appropriate decisions.

- (iv) *How would the proposal improve protection for consumers?*

Unlike water companies, NWOs do not have routine contact with the majority of consumers who are served by their networks. However, consumers will benefit from improvements to the ring fence regime (including a requirement for SIDs) which will promote financial stability and continuity of network operations.

- (v) *NWO boards are executive in nature; the presence of non-executives might hamper effective decision making.*

The appointment of SIDs may mean that some additional formality is added to board level governance of NWOs and we do not view this as a bad thing. However, we do not consider that the requirement should impinge on prompt and effective decision implementation, especially with regard to the routine management affairs of NWOs.

- (vi) *NWOs are incentivised to behave in a commercial manner, especially under RIIO price control arrangements and should not be subject to ring fence requirements which could cause them to act in a risk averse way.*

As protected energy companies NWOs do have special status. However, we do not consider that a requirement to have SIDs on their boards should affect their commercial posture or lead them to act in a risk averse way.

- (vii) *Independent non-executives at listed company level (where applicable) already have an overview of all companies within the relevant group.*

We acknowledge this and attach importance to the contribution made to good governance throughout a group and the regard that group non-execs have for regulatory compliance issues. However, group non-execs do not have the characteristics of independence as regards the NWO which the proposed SIDs would have.

- (viii) *The role of SIDs on an NWO board might conflict with the roles of group non-execs.*

We think this is very unlikely since the interests promoted by both should normally be aligned. However, NWO SIDs may be able to contribute to governance from a different perspective and should be relatively immune to conflicts as far as the NWO's interests are concerned, even in extreme circumstances. It is also relevant to note that only a few NWO groups are headed by UK listed companies.

- (ix) *Most NWOs are already required to produce corporate governance statements as if they were a UK listed company [under the Regulatory Accounts condition].*

This is an important requirement and the quality of submissions is improving. We consider this to be an area of governance where SIDs can make a positive contribution which should benefit the NWO and its owners.

- (x) *Independent directors don't have a great track record in preventing financial failures.*

We do not consider that the appointment of SIDs would of itself be proof against financial distress. However, their ability to provide an unconflicted view in all circumstances will be beneficial as part of the overall ring fence regime.

- (xi) *Wouldn't it be better for Ofgem to concentrate on risky capital structures?*

Much of the financing utilised by NWOs is raised at group level and we have no direct regulatory remit in this regard. Whilst we do pay attention to this wider picture in terms of financial monitoring and reviewing price control arrangements it is for business owners and managers to organise capital structures in a way which ensures the NWO can comply with all of the terms of its licence at all times, and SIDs should be able to make a useful contribution to this process.

- (xii) *Shouldn't NWOs affected by more risky group financial structures be subject to more restrictions than those in safer structures?*

The ring fence restrictions are contained in standard conditions of NWO licences which should generally be consistent across licenses of a particular type. However, we have sought to draft the proposed changes so that the requirements are not onerous for NWOs subject to sound financing arrangements and good corporate governance.

- (xiii) *The conflict of interest argument has been over-stated – it would always be in the interest of all parties for the NWO to remain compliant with its licence.*

Whilst this is true in normal circumstances, executives might be conflicted at times of exigency (see comments in chapter 4).

- (xiv) *It might be better to require NWOs to designate a 'compliance director' with reserved powers on certain matters, such as the approval of Availability of Resources certificates.*

This suggestion has some merits but such a director may not have sufficient independence in the context of the objectives we have set out. In addition, a regulatory requirement along these lines might be considered regulatory interference with the unitary nature of a board.

- (xv) *If credit rating agencies saw a need for independent directors at NWO level they would press for them.*

Whilst we have referred in chapter 3 to the ongoing relevance of credit ratings to NWOs, these proposals are not driven by rating considerations.

- (xvi) *Wouldn't appointment by a single shareholder mean that the SIDs should act in the interests of that shareholder?*

All of the directors of a company have a duty to act in its interests which will almost always align with those of its shareholder(s). However, if there is a conflict between the best interests of the company and the interests of its shareholder(s), a director has a duty to act in the interests of the company. SIDs should be able to bring an unconflicted view in this regard in all circumstances.

- (xvii) *Why not allow non-executive directors of NWO affiliates to be appointed as SIDs?*

Although non-executives within a group make a valuable contribution to overall governance, they would not be independent with respect to the NWO itself. However, our revised drafting of the proposed condition allows for the same person to be a SID of different NWOs with the same group because the risk of independence being compromised in this scenario is very small.

- (xviii) *It may not be appropriate to give reasons for the resignation of a SID if they are personal.*

Our revised drafting of the proposed condition provides for these to be stated as 'personal reasons'.

(xix) *The condition should provide for unavoidable vacancies which may arise.*

Our revised drafting of the proposed condition provides for this.

(xx) *A requirement for a majority of independent licensees would be more onerous than the one some listed companies are subject to. Only FTSE 350 companies have to have half the board as independent directors.*

Our revised proposal is for two SIDs and so they need not be in a majority on the NWO's board.

Appendix 5 - Summary of questions

CHAPTER: One

Question 1: Have we identified the risks and concerns which are important to you if you are:

- a network user (consumer, generator, shipper or supplier)?
- a finance provider, network owner or other stakeholder?
- a network operator?

Question 2: Do you think that any of our proposals will require deferred start dates to allow NWOs to make preparations for compliance?

CHAPTER: Three

Question 1: Do our proposed changes to the existing ring fence conditions effectively address the risks which we have identified in a proportionate way?

Question 2: Have we satisfactorily addressed the responses to our initial consultation in terms of the impacts and alternatives which were raised?

Question 3: Do you think that our proposals will enhance the synergic working of the ring fence and the concept of a defence in breadth and depth against financial or operational distress?

Question 4: Do you agree with the exceptions to applicability we have set out for certain types of NWO?

Question 5: Have we drafted conditions which are clear and concise – or are there improvements that we could make?

CHAPTER: Four

Question 1: Do you think our revised proposal to require NWOs to have two sufficiently independent directors (SIDs) is proportionate and addresses the risks we have identified particularly in relation to possible conflicts of interest?

Question 2: Does our revised proposal alleviate the concerns about legitimate influence and control by NWO owners raised in relation to our initial proposal to require a majority of independent directors?

Question 3: Do you have any comments on the alternative approaches which are referred to?

Question 4: Is our draft condition for sufficiently independent directors clear and concise, or could the drafting be improved?

Question 5: If a requirement for SIDs is introduced, how much lead time do you think should be allowed for candidates to be selected and appointed?

Question 6: Do you agree that the proposed condition for sufficiently independent directors should not apply to independent gas and electricity distribution network operators nor to offshore transmission operators?

Appendix 6 – Information on energy networks in Great Britain

Background

1.1. Energy network businesses perform a key role in the economic and social wellbeing of consumers and commercial enterprise in Great Britain. They are responsible for transporting gas and electricity from production/import sites to the premises of domestic and commercial consumers and derive their income from use of system charges paid by shippers²⁵ and suppliers who, in turn, pass on these charges to consumers as part of their energy bills.

1.2. There are four energy transmission businesses²⁶, fourteen regional electricity distributors and eight regional gas distributors²⁷. There are also a number of independent gas and electricity distribution licensees who own and operate smaller networks at various locations across Great Britain.

1.3. In addition a number of offshore transmission assets are presently being developed and there are several interconnector licensees operating network assets which connect the GB energy networks to those in other countries.

1.4. Maps showing the disposition of the gas and electricity distribution networks in Great Britain are shown on the next two pages. For further information on energy networks and the companies which hold licences please see the relevant summary pages on the Ofgem website under:

<http://www.ofgem.gov.uk/Networks/>

²⁵ In gas distribution, shippers arrange for the transportation of gas on behalf of suppliers. There is no equivalent for electricity distribution where suppliers deal directly with distributors.

²⁶ National Grid Electricity Transmission plc is the 'system operator' for electricity transmission throughout Great Britain, but the transmission assets in southern and northern Scotland are owned and maintained by SP transmission Ltd and Scottish Hydro Electric Transmission Ltd respectively. National Grid Gas plc own and operates the gas transmission system throughout Great Britain.

²⁷ Four of the gas distribution networks are operated under a single licence by National Grid Gas plc.

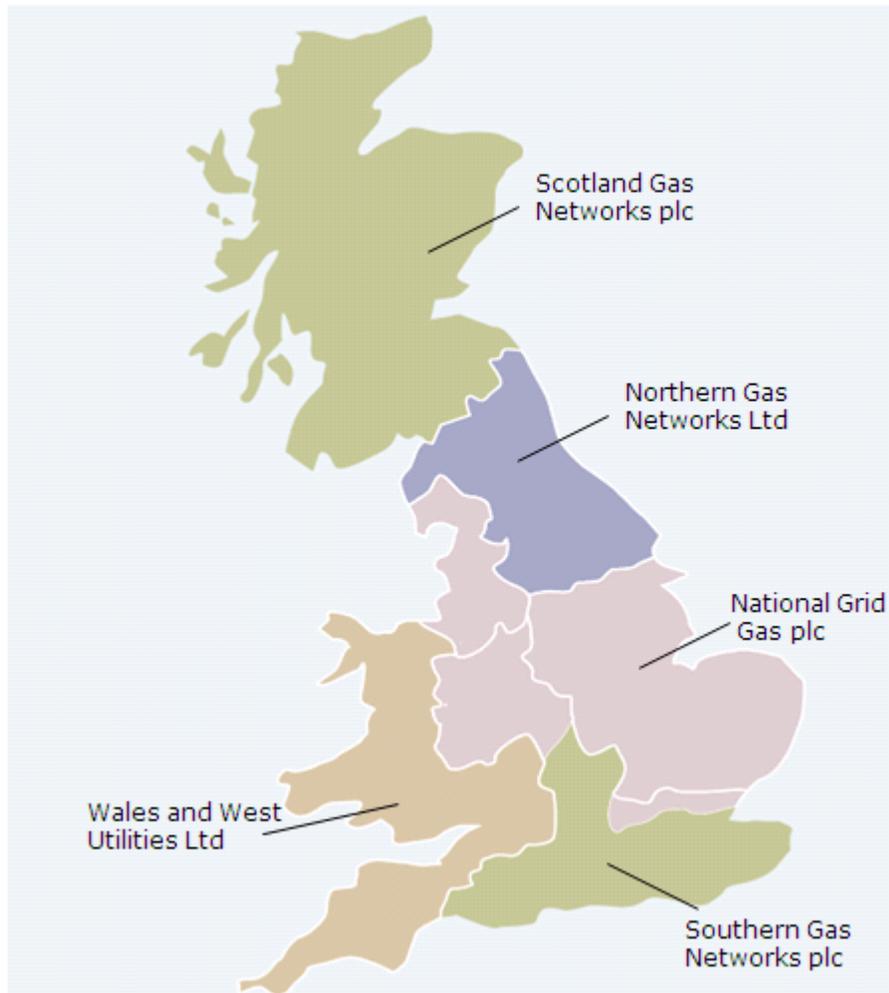
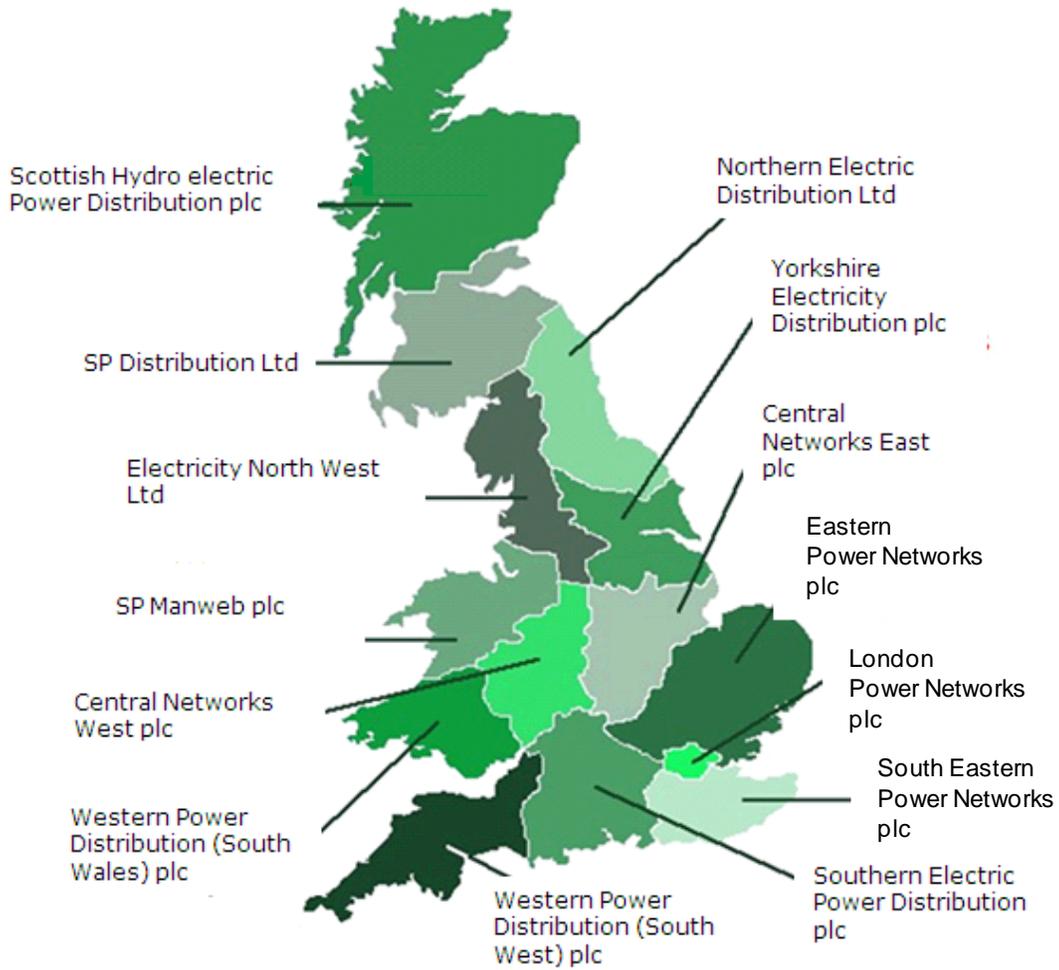
Figure A6.1 - Map showing regional gas distribution network licensees

Figure A6.2 - Map showing regional electricity distribution network licensees



Appendix 7 – The Authority’s powers and duties

1.1. Ofgem is the Office of Gas and Electricity Markets which supports the Gas and Electricity Markets Authority (“the Authority”), the regulator of the gas and electricity industries in Great Britain. This appendix summarises the primary powers and duties of the Authority. It is not comprehensive and is not a substitute to reference to the relevant legal instruments (including, but not limited to, those referred to below).

1.2. The Authority's powers and duties are largely provided for in statute (such as the Gas Act 1986, the Electricity Act 1989, the Utilities Act 2000, the Competition Act 1998, the Enterprise Act 2002 and the Energy Acts of 2004, 2008 and 2010) as well as arising from directly effective European Community legislation.

1.3. References to the Gas Act and the Electricity Act in this appendix are to Part 1 of those Acts.²⁸ Duties and functions relating to gas are set out in the Gas Act and those relating to electricity are set out in the Electricity Act. This appendix must be read accordingly.²⁹

1.4. The Authority’s principal objective is to protect the interests of existing and future consumers in relation to gas conveyed through pipes and electricity conveyed by distribution or transmission systems. The interests of such consumers are their interests taken as a whole, including their interests in the reduction of greenhouse gases and in the security of the supply of gas and electricity to them.

1.5. The Authority is generally required to carry out its functions in the manner it considers is best calculated to further the principal objective, wherever appropriate by promoting effective competition between persons engaged in, or commercial activities connected with,

- the shipping, transportation or supply of gas conveyed through pipes;
- the generation, transmission, distribution or supply of electricity;
- the provision or use of electricity interconnectors.

1.6. Before deciding to carry out its functions in a particular manner with a view to promoting competition, the Authority will have to consider the extent to which the interests of consumers would be protected by that manner of carrying out those functions and whether there is any other manner (whether or not it would promote competition) in which the Authority could carry out those functions which would better protect those interests.

1.7. In performing these duties, the Authority must have regard to:

- the need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met;

²⁸ Entitled “Gas Supply” and “Electricity Supply” respectively.

²⁹ However, in exercising a function under the Electricity Act the Authority may have regard to the interests of consumers in relation to gas conveyed through pipes and vice versa in the case of it exercising a function under the Gas Act.

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- the need to secure that all reasonable demands for electricity are met;
- the need to secure that licence holders are able to finance the activities which are the subject of obligations on them³⁰; and
- the need to contribute to the achievement of sustainable development.

1.8. In performing these duties, the Authority must have regard to the interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.³¹

1.9. Subject to the above, the Authority is required to carry out the functions referred to in the manner which it considers is best calculated to:

- promote efficiency and economy on the part of those licensed³² under the relevant Act and the efficient use of gas conveyed through pipes and electricity conveyed by distribution systems or transmission systems;
- protect the public from dangers arising from the conveyance of gas through pipes or the use of gas conveyed through pipes and from the generation, transmission, distribution or supply of electricity; and secure a diverse and viable long-term energy supply, and shall, in carrying out those functions, have regard to the effect on the environment.

1.10. In carrying out these functions the Authority must also have regard to:

- the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed and any other principles that appear to it to represent the best regulatory practice; and
- certain statutory guidance on social and environmental matters issued by the Secretary of State.

1.11. The Authority may, in carrying out a function under the Gas Act and the Electricity Act, have regard to any interests of consumers in relation to communications services and electronic communications apparatus or to water or sewerage services (within the meaning of the Water Industry Act 1991), which are affected by the carrying out of that function.

1.12. The Authority has powers under the Competition Act to investigate suspected anti-competitive activity and take action for breaches of the prohibitions in the legislation in respect of the gas and electricity sectors in Great Britain and is a designated National Competition Authority under the EC Modernisation Regulation³³ and therefore part of the European Competition Network. The Authority also has concurrent powers with the Office of Fair Trading in respect of market investigation references to the Competition Commission.

³⁰ Under the Gas Act and the Utilities Act, in the case of Gas Act functions, or the Electricity Act, the Utilities Act and certain parts of the Energy Acts in the case of Electricity Act functions.

³¹ The Authority may have regard to other descriptions of consumers.

³² Or persons authorised by exemptions to carry on any activity.

³³ Council Regulation (EC) 1/2003.

Appendix 8 - Glossary

D

DECC

Department of Energy and Climate Change.

DNO – Distribution Network Operator (electricity)

One of the licensed operators of the fourteen regional electricity distribution networks in Great Britain.

G

GDN - Gas Distribution Network Operator

One of the licensed operators of the eight regional gas distributions networks in Great Britain (four of which are owned and operated by National Grid Gas plc).

I

IDNO - Independent (electricity) Distribution Network Operator

An electricity distributor whose licence was granted after 1 October 2001 and whose licence does not contain obligations relating to a geographical distribution services area.

IGT - Independent Gas Transporter

A gas transporter whose licence was granted after the 1995 amendment of the Gas Act 1986 and whose licence does not contain obligations relating to a geographical distribution services area.

N

NWO - Network Operator

A person holding an electricity transmission, electricity distribution or gas transporters licence. All the holders of such licences in Great Britain are corporate persons i.e. companies registered at Companies House.

O

OFTO – Offshore Transmission Owner

A person (company) holding an electricity transmission licence allowing it to own, operate and maintain one of the electricity transmission networks linking offshore wind farms to the GB mainland.

P**Protected Energy Company**

Protected energy company" means a company which is the holder of a relevant licence; and

"relevant licence" means—

- (a) a licence granted under section 6(1)(b) or (c) of the Electricity Act 1989 (transmission and distribution licences for electricity); or
- (b) a licence granted under section 7 of the Gas Act 1986 (licencing of gas transporters).

R**Related Party**

Used in this document as generic term and covering:

- Affiliate – a holding company of the licensee, a subsidiary of the licensee and any subsidiary of a holding company of the licensee
- Related undertakings – a company in which the licensee hold a participating interest – generally a shareholding over 20%.

Reopener

A process to re-set revenue allowances (or the parameters that give rise to revenue allowances) under a price control before the next formally scheduled review date for the relevant price control.

RIIO

Revenue = Incentives + Innovation + Outputs.
Ofgem's new framework for the economic regulation of energy networks.

S**Special Administration**

A formal insolvency procedure based on the normal administration process but with the specific objective of ensuring that an energy network continues to be maintained and developed as an efficient and economical system either by the rescue of the NWO company as a going concern or by the transfer of the distribution business as a going concern to one or more different companies.

T**The Authority (Ofgem)**

Ofgem is the Office of Gas and Electricity Markets, which supports the Gas and Electricity Markets Authority (GEMA), the body established by Section 1 of the Utilities Act 2000 to regulate the gas and electricity markets in Great Britain.

Appendix 9 - Feedback questionnaire

1.1. Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

1. Do you have any comments about the overall process, which was adopted for this consultation?
2. Do you have any comments about the overall tone and content of the report?
3. Was the report easy to read and understand, could it have been better written?
4. To what extent did the report's conclusions provide a balanced view?
5. To what extent did the report make reasoned recommendations for improvement?
6. Please add any further comments?

1.2. Please send your comments to:

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