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Dear Paul

Proposed Modifications to the "Ring fence" Conditions in Network Operator Licences (Ref 42/11)

National Grid owns and operates the high voltage electricity transmission system in England and Wales and, as National Electricity Transmission System Operator (NETSO), operates the high voltage transmission system throughout Great Britain and offshore. National Grid also owns and operates the gas transmission system throughout Great Britain (NTS) and, through our gas distribution business, distributes gas in the heart of England to approximately 11 million offices, schools and homes.

National Grid would potentially be subject to the proposed modifications to the "ring fence" conditions in its electricity transmission licence in respect of its role as NETSO and in its two gas transporter licences in respect of the NTS and gas distribution networks it owns. National Grid therefore welcomes the opportunity to respond to this consultation.

This response is in two parts:

- general comments on the issues raised by the consultation, including, in particular, why it would not be justified or beneficial to create a licence requirement for independent directors on the boards of NWOs; and
- an Appendix which gives responses to the specific questions raised by the consultation.

We also enclose a scanned copy of those parts of Appendices 10 to 14 to the consultation which set out the drafting proposed for the licences applicable to National Grid, on which we have marked up some detailed drafting comments.

1 Executive Summary

We should first like to make clear National Grid's continuing concern with the Authority's decision to consult again on the ring fence regime and the proposal to introduce a further requirement, the appointment of "sufficiently independent" directors (SIDs), where no evidence has been produced that the existing regime is deficient or that licensed businesses have failed to comply with that regime. Although we note that the proposal is now for two such directors rather than a majority, we believe that the proposed new condition is unjustified and without merit, for reasons which include:

- the proposal for SIDs addresses neither the areas where Ofgem claim the existing ring fence leaves room for improvement nor the new risks that are identified in the consultation;
- the justification for SIDs in the new consultation appears to be based on a misunderstanding of company law. Not only do all directors have a statutory duty to avoid actual or potential conflicts of interests with the company, but those same directors (whether SIDs or executive directors) also have a duty to promote the success of the company. These duties are owed to

the company for the benefit of its members as a whole (or creditors in times of impending financial failure). As such, directors are bound by a clear duty which prohibits them from "*prefer[ing] the interests of the NWO*" itself over the interest of its shareholder(s);

- on a proper interpretation of company law and the meaning of "members", the conflicts of interest which Ofgem seeks to address cannot arise, particularly where a licensee has a single shareholder;
- the Companies Act does not differentiate between the duties of executive and non-executive directors, and Ofgem has acknowledged that there is "*no reason to believe that existing licensee directors do not perform their duties in accordance with requirements of companies legislation*";
- it must be remembered that consumers' interests are already protected effectively by the existing ring fence regime and other requirements of network licences. These rules are reinforced by the incentives in price controls to operate these businesses not only in an economic and efficient manner, but also on a basis that is financially and operationally sound;
- where a NWO is a subsidiary of a publicly listed company which is subject to the UK Corporate Governance Code and so is required to have a majority of non-executive directors on the listed company board, it is clear that the obligations of the non-executive directors extend to and encompass the subsidiaries; and
- in addition to the external scrutiny and reporting obligations of NWOs themselves (which are akin to those of listed companies where they issue listed debt), publicly listed UK companies are subject to extensive disclosure rules that operate on a continuing real time basis and which would generally include significant changes to the financial position and results of operations of their principal subsidiaries. There is also significant scrutiny by external interests including external auditors, analysts and other market participants. As a result, for these companies (and their subsidiaries) SIDs at NWO level would be most unlikely to provide any earlier warning of potential future financial difficulties than the arrangements already in place.

These points are explained more fully in Section 3 below. As a result, the justification for the proposal that has been put forward is ill-founded, and the new licence condition which would introduce a requirement for the appointment of SIDs to the boards of our licensee companies should not be taken forward.

Ofgem has failed to demonstrate that any change to the ring fence regime is necessary, as (by its own admission) network operators all survived the financial crisis of 2008 unscathed, notwithstanding that this was the worst financial crisis in 80 years.[1] The ring fence conditions also need to be seen within the context of the overall incentive-based framework of energy network regulation in the UK. A fundamental principle of this framework is that interference in the management, operation, financing, and structure of the businesses should be kept to a minimum, and consequently there should be a presumption against any extension to the ring fence conditions already in place unless direct and significant benefits have been clearly demonstrated.

Nevertheless, except for the proposed new licence condition concerning SIDs, the proposed changes to the existing ringfence provisions appear to be fairly limited. Although neither necessary nor justified, they could mostly be implemented without undue cost or administrative burden on the licensees.

Given that any changes implemented will need to be funded and that there is no pressing need for any of the changes proposed, no amendments should be made until the next full price control reviews, and only then where it is clear that they will provide a clear cost benefit to consumers.

2 The proposed changes have not been justified

On the most fundamental level, Ofgem has failed to demonstrate as a matter of fact that any change to the ring fence regime is necessary, or which of the proposed measures (apart from the restriction on

[1] The new consultation notes that "*The ringfence arrangements have worked well since they were put in place during the 1990s.*" and "*They have worked well, and none of the network operators has to date been seriously affected by the 'credit crunch' of the recent financial downturn*".

receivables financing) would actually address the "new" risks identified from the financial crisis. Further, Ofgem asserts that the augmented conditions should address concerns that the existing ring fence is too finance-focused. It is hard to see how this statement is justified, given that the "new" risks used to justify the proposed changes (see paragraph 1.9 of the consultation) are financial in nature.

Ofgem neither demonstrates that the consequence for consumers of a NWO getting into financial difficulties are inevitable, nor that they would have any wider effect than on the network operator concerned. It appears more likely that any loss would be borne by the shareholders and lenders of the licensee (for example on sale of the business out of an energy administration) and that there would only be an increase in financing costs beyond the licensee in question if the financial difficulties faced by one licensee indicated a systemic problem with, for example, the price control settlements applied across the board (in which case the problem should be resolved by Ofgem and any corrective action would simply "rectify" a settlement that had previously been too generous to consumers).

Ofgem also asserts that the proposals will facilitate the use of price control reopeners, but the experience of the demise of *Railtrack* indicates that these procedures may need to be utilized on very short timescales in order to be effective. None of the present proposals would have any impact on this.

Finally, it should be recognized that the proposals will inevitably lead to increased costs for consumers without any demonstrable corresponding benefit, and so these changes cannot, either individually or collectively, be described as being necessary or expedient to protect the interests of consumers. This is backed up by Ofgem's own admission in its original consultation that their consultants had not provided any evidence that changes were either needed or would provide any additional safeguard for consumers. As such, these changes do not pass the test for inclusion in the relevant licences and should not be pursued.

3 The proposed condition requiring appointment of Sufficiently Independent Directors (SIDs)

We continue to consider that an obligation to appoint "sufficiently independent" directors is not warranted. The new consultation fails to address the comments on this proposal which were contained in our previous letters of 23rd April 2010 and 12th November 2010 and which are set out and developed below.

The consultation claims there are three areas where the existing ring fence conditions leave some scope for improvement, but this proposal for SIDs does not respond to any of these:

- there is no basis to suppose it would give an increased focus on operational resourcing;
- it would not mitigate the severity of financial distress should it arise;
- as explained in sections 3.3 and 3.4 below, the requirement would be highly unlikely to provide any "early warning" benefit over and above that already in place, particularly for those NWOs which are subsidiaries of listed companies and for those NWOs which issue listed debt.

It is also not an effective or appropriate way of addressing any of the "*relevant risks*" identified at paragraph 1.9 of the consultation, particularly given Ofgem's acknowledgment that:

- these are risks that apply to "*corporate groups*", and which consequently need to be managed and resolved at group (rather than NWO) level;
- "*the likelihood of an NWO experiencing financial distress because of problems at corporate group level is relatively small*";
- "*primary responsibility for the financial well being of each network operator lies with its managers and owners*"; and
- it would not be *"commercially desirable*" to eliminate the risk that financial distress could affect a network operator as this risk is part of the drivers for efficient behaviour.

3.1 Company Law and the existing licence requirements are sufficient and effective

The proposed obligation must be seen in the context of company law. As we have commented previously, the duties of directors under the general law and the Companies Act 2006 provide reasonable and proportionate assurance of network and customer protection in the event of actual or potential financial distress.

The directors of an NWO are already obliged to take into account the company's regulatory responsibilities and the interests of consumers in carrying out their duties. We cannot agree with Ofgem's disregard for the range of existing sanctions for company directors: directors are always very mindful of their responsibilities and the sanctions under companies legislation for their breach. Indeed, the sanction of disqualification from acting as a director provides a very real incentive for Directors to take their responsibilities and duties seriously.

In any case, the Companies Act does not differentiate between the duties of executive and non-executive directors.

To the extent that Ofgem's underlying concern is that consumers' interests may not be properly prioritised by licensees, NWOs are already obliged in a practical sense to consider these interests through the requirements of the licence in its entirety. Furthermore, under the Companies Act 2006, directors have a duty to promote the success of the company, and in so doing they must have regard to a number of factors including the long term consequences of any decision, the need to foster business relationships with suppliers and others, and the desirability of maintaining a reputation for high standards of business conduct. It is difficult to conceive of circumstances where the directors of a regulated utility would not pay due attention to these requirements, as the interests of shareholders and others will best be served by ensuring ongoing licence compliance.[2]

In addition the consultation fails to recognise the requirement under sections 171 -177 of the Companies Act 2006 for all directors to avoid conflicts of interest. This failure undermines Ofgem's concern that existing directors might be "conflicted" and as a consequence could act in breach of the Companies Act.

In any event, it is unclear why Ofgem has this concern since it has acknowledged that there is "*no reason to believe that existing licensee directors do not perform their duties in accordance with requirements of companies legislation*", making it unclear what different behaviours they wish to see either from SIDs specifically or from a licensee's Board as a body.

3.2 The proposal is based on a misunderstanding of Company law

The definition of SIDs[3] specifies that they "*must not represent the particular interest of any shareholder or group of shareholders of the licensee or the interests of any affiliate or related undertaking of the licensee*". This appears to be, or at least has the potential to be, in conflict with company law: as the consultation notes at Paragraph 4.21, the Companies Act directs all directors (whether executive or non-executive) to act in the interest of the members[4]. Where there is a single shareholder, it would be clear that all directors would be required to act in the interests of this member, at odds with the proposed definition. As CE put it in their consultation response last April, "*If Ofgem really has a problem with directors of subsidiary companies behaving in the interests of the members (rather than as Ofgem would appear to wish them to) this implies a problem with the model of a profit-seeking company pursuing the interests of its shareholders within the limits of the law"* in which case the

[2] The Ultimate Controller Undertaking, which requires the ultimate controller (and its other subsidiaries) to refrain from actions that would be likely to cause the licensee to breach its licence, is also relevant to this.
[3] Paragraph 4.2
[4] Members means shareholders – see section 172 of the Companies Act 2006. As such, we consider Ofgem's analysis of paragraph 4.21 and 4.22 of the consultation to be fundamentally flawed. Given the duty of directors to "promote the success of the company for the benefit of its members as a whole", where there is a single shareholder (i.e. single member), the duties of all directors would be clear, and (as for any company) the duties of executive and non-executive directors (including SIDs) would be the same.

remedy would be *"to move to a different model of ownership altogether, such as the Scottish Water, Glas Cymru or Network Rail approaches to the provision of regulated services.*" Such a change is beyond the scope of the current consultation and would be incompatible with the conclusions of the recently concluded RPI-X@20 review, and we do not believe Ofgem consider it would be in the interests of consumers.

At Paragraph 4.43, the consultation asserts that there are two broad benefits which a requirement for SIDs at NWO level would bring, over and above the existing benefits from non-executive directors on the group board:

- it would assert the (separate) identity of the NWO as a protected energy company; and
- the SIDs would provide an unconflicted voice of reason with respect to the interests of the licensed NWO business.

However, it clearly follows from the discussion above that neither of these two claimed benefits have any foundation, particularly where a licensee has a single shareholder.

3.3 SIDs would not address other possible objectives

As for SIDs providing an early warning of financial problems, (by Ofgem's own admission) independent directors in other contexts have not always been able to spot or prevent financial predicaments, and in their report for Ofgem CEPA questioned whether SIDs would bring any real benefits[5]. It is also relevant that listed companies are subject to extensive disclosure rules and significant public and financial scrutiny by external interests. In accordance with the Listing Rules of the Financial Services Authority, such companies must issue a RNS announcement to make public any board changes, including any resignation by a non-executive director of the listed company. There is also further external scrutiny of NWO subsidiaries where they issue listed debt finance. As a result, for these companies (and their subsidiaries) SIDs at NWO level would be most unlikely to provide any additional "early warning" of potential future financial difficulties that were not already public knowledge.

It is also claimed in the new consultation 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.*" (see Paragraph 4.5). This is no more than an assertion which is neither explained nor justified: given the importance of licence compliance and the significant financial, reputational and indirect consequences of breaches (both personally and for the corporate body), all licensee directors and their owners place paramount importance on maintaining a high level of focus on licence compliance. There is no basis for an assertion that SIDs would attach any more importance to compliance than executive directors.

3.4 Group Governance, Requirements of Listed Companies and the Corporate Governance Code

Ofgem argues that good governance at group level cannot provide a sufficiently independent voice at licensee level. We do not consider that this assertion is consistent with company law as the obligations of directors at group level clearly extend to the companies lower down in the corporate group. Where a NWO's parent company is publicly listed, the UK Corporate Governance Code (formerly the Combined Code on Corporate Governance) requires the appointment of suitably qualified and experienced directors, and requires the board to be made up of a majority of independent non-executive directors. The role and obligations of the non-executive directors at the listed company level under the Code clearly extend to and encompass subsidiaries, such that the

[5] "Assessment of Ofgem's Financial Ring Fence Conditions – a report for Ofgem", Cambridge Economic Policy Associated Ltd, October 2009, section 7.6: CEPA acknowledged that "*We have doubts that the additional non-executive board members are likely to have a significant impact*" and "*Under company law ….. directors have a duty to promote the success of a company for the benefit of its members. Where there are no independent shareholders, it is not clear that an independent director can interpret his or her duty in a different way from an executive director.*" In fact, as we have stated, it is clear that a non-executive director cannot interpret his or her duties in a different way from an executive director.

NWOs within the group already benefit from the skills, experience and role of the non-executive directors of the listed company. For example the obligation under the Code for the board of the listed company to conduct a review of risk management and internal control systems at least annually and report on this to shareholders. In addition, the "ultimate controller undertaking" provides a further link from the listed company to the NWO, and a further protection for consumers.

In this context, it should also be remembered that electricity transmission and gas transporter licensees already have a requirement for a statement concerning their application of the UK Corporate Governance Code in their regulatory accounts. This should be sufficient to enable Ofgem to assess the manner in which a particular licensee is being run.

We do not believe that a requirement for SIDs would improve corporate governance at NWO level, nor would it help address the types of compliance issue which have given rise to recent Ofgem investigations. Those matters have arisen for very specific reasons, and it is unlikely that the presence of SIDs on the NWO boards would have had any impact on the circumstances in which those issues arose.

Furthermore, under current law the administrators of the company would investigate the directors' conduct closely and also would have rights to claw back funds transferred if the company in question were in or close to insolvency when these transfers happened. In relation to UK listed companies at least, absent concealment, it is very difficult to see how a company could fall into administration without the warning signals being evident a long time in advance and those warning signals being picked up on and reflected in the market (and if concealment exits, it is very unlikely that the SIDs would expect to see the true situation). As such, it is difficult to see what this proposal to require the appointment of SIDs adds.

In any event, given that Ofgem is seeking to distinguish between the rules applicable to different types of licensee (not that offshore transmission licensees are in reality a different class of licensee from other electricity transmission licensees, each holding an electricity transmission licence) we do not see why other, more relevant factors (such as the level of oversight by financial markets) cannot be factored into Ofgem's proposals. As such, to the extent that a licensee is subject to the spotlight of the transparency and corporate governance rules required by a stock market listing at group level, the ring fence rules should be less intrusive as the market will act as a much more effective indicator and provide earlier warning of impending problems than any of the proposed changes to the regime.

4 Charge over receivables (proposed change to Disposal of Assets condition)

Ofgem indicates that one of its concerns is that a creditor might hold a qualifying charge enabling it to appoint an administrator. If Ofgem's concern is that a particular creditor might thereby have effectively too much power over the financial position of the licensee, it would appear that a better solution, if any change is indeed necessary, would be simply to prohibit licensees from creating charges over receivables which create this right, rather than a blanket ban on all charges over receivables.

5 Certificate of operational resources

Ofgem does not appear to have taken seriously the difficulties of assessing third party risk in the giving of a resources certificate. In particular, while licensees may hear rumours about their suppliers through their day-to-day contacts and, where prudent, will act on them, it does not appear to be sensible, practicable or justifiable for licensees to be required to comment on these matters in a certification process which is backed up by licence breach proceedings against the licensee. As the financial crisis shows, suppliers can collapse very quickly albeit there may have been market intelligence on them for some time. It is not at all clear from the consultation what approach Ofgem intends licensees to take towards such market intelligence in its certification process (or indeed, that this will not effectively drive all licensees always to give a qualified certificate out of an abundance of caution). This latter approach would be of little merit to the Authority in seeking to "weed out" cases of concern from those which are not.

The proposed revised licence drafting for the "Availability of resources" condition also seeks to make a further change, to replace the current requirement for licensees to confirm the availability of financial facilities with a requirement to submit "*a summary of the financial facilities available to the licensee*". This is a material change which is not raised in the new or previous consultations. As such no benefits have been claimed for this change, it has been neither justified nor consulted upon, and it should not be taken forward.

6 Intervention plan

While we consider that such a plan may be of use to an administrator, we do not see that this proposal can have any impact on the likelihood of a licensee entering into financial difficulties in the first place: rather it is of use only once the financial difficulties have become very severe. As such, while unobjectionable in itself, it is not clear that this proposal can benefit from any of the proposed justifications for change set out in the consultation document.

7 Additional Cash lock up triggers

It is not clear what, if any, additional benefit the proposed extension to trigger the "cash lock-up" provisions on material breach of a financial covenant would provide in terms of early warning of financial problems. It risks being too "heavy handed" or having unintended consequences in an attempt to apply the cash lock-up in potentially deteriorating financial circumstances in advance of a change to credit ratings. For example, a cash-lock up for breaches or renegotiation of financial covenants triggered by changes in accounting standards would be unmerited if the fundamental strength of the company is unchanged. Ofgem needs to re-assure the industry that the revised condition would not apply in such circumstances, and any implementation of this change should be drafted carefully to avoid such undesirable and unintended outcomes.

The proposed extension to the Indebtedness licence condition fails to recognise the extent of information that Ofgem already gather on licensees' performance and financial affairs, and the early warning that these arrangements already provide. In addition, the recent case of *Focus DIY* falling into administration indicates that a breach of a financial covenant may occur almost immediately before administration. As such, it is not clear to what extent this provision would provide any benefit, especially as an administrator would be able to claw back any improperly paid dividends paid prior to the insolvency.

The proposed extension to apply "cash lock-up" in circumstances where a "Certificate 3" has been provided should not apply where this form of certificate has been provided for reasons that relate to non-financial matters: such reasons are unlikely to be addressed or improved by applying cash lock-up, which would consequently become a penalty or a disincentive rather than being a reasonable and proportionate measure.

8 Undertaking from Ultimate Controller

These provisions appear to add little or nothing to the existing arrangements. While for administrative purposes it might be useful for Ofgem to have a list of ultimate controllers, it appears that a slight amendment to the existing ultimate controller obligations to make clearer the licensee's obligation to notify Ofgem of a change of ultimate controller would be sufficient. As for the requirement for the licensee to write to the ultimate controller reminding it of its duties on an annual basis, this appears to have little practical merit.

9 Impact assessment

Ofgem asserts that serious new risks have emerged from the global liquidity crisis (see paragraph 5.10), yet this assertion does not seem founded on the consultants' views as previously expressed, nor has Ofgem quantified adequately either the costs of the proposals, or the benefits of them. As such, it it hard to see how the impact assessment provides an adequate insight into the costs or benefits of the proposals.

10 Conclusions

We are very concerned that Ofgem is seeking to move forward with a further consultation on this matter, not only in the face of the concerns of respondents, but more particularly in the face of the observed facts about the effective operation of the ring fence provisions over the last few years and that further costs will be incurred by customers in circumstances when the need for those additional costs has not been justified.

Given that the proposed modifications set out in the new consultation are largely unchanged from those previously proposed last October, our principal reservations and concerns remain. We urge Ofgem to reconsider the proposals carefully in the light of the responses to the previous consultation and of this (and other) responses to the new consultation. It would be premature for Ofgem to reach a final decision on the proposals and issue a formal notice of proposed licence modifications before a proper justification has been published which shows that the proposed changes, both individually and collectively, are both justified and proportionate.

Our strongest concerns relate to the proposed new requirement for sufficiently independent directors at the NWO level. We consider that this proposal in particular fails the basic test for the introduction of licence conditions set out in the Gas and Electricity Acts, that they be "requisite or expedient" to promote the duties of the Authority. There is no such evidence and therefore we struggle to understand why the Authority is seeking to continue with consultation on this change. We remain opposed and believe that Ofgem should not proceed with the proposal to introduce a requirement for SIDs at NWO level, especially where the ultimate parent is a public limited company subject to the UK Corporate Governance Code and the other obligations of a listed company.

Yours sincerely

[By e-mail]

Paul Whittaker
UK Director of Regulation

c.c. Rachel Fletcher – Partner, Smarter Grids & Governance

APPENDIX – Responses to the Specific Questions raised in the Consultation

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?

Ofgem has not identified any new risks arising from the financial crisis since 2008, as any risks that exist today already existed before the crisis. It is also unclear what, if any, specific behaviour or actions by licensees, that are currently permitted under both UK law and existing licences, Ofgem now wish to stop.

The consultation does not, and does not seek to, address the principal risks and concerns faced by NWOs. Indeed, the opening paragraph of the "Context" section of the consultation reads "*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*." It is the corollary of this responsibility that NWOs should not be subject to additional restrictions through unnecessary changes to the ring fence licence conditions.

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

The risks and uncertainties faced by NWOs are assessed by Ofgem as part of the formal price control review process, and in that context are considered in accordance with Ofgem's "Financing duty". In practice, the principal risk faced by NWOs and so indirectly faced by other stakeholders (including consumers, network users and finance providers) is that network revenues allowed under a price control are insufficient for an efficient operator to meet its obligations and provide an acceptable return to its investors and lenders, either because of risks/uncertainties that had not been anticipated or because cost and performance targets set through the control are unachievable. This risk is not, and cannot, be addressed by the ring fence conditions. However, this much greater risk forms an important part of the regulatory backdrop against which the proposed licence changes, their costs, and any small reductions in risk they might bring need to be judged.

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

The proposed amendment to the "Ultimate Controller" licence condition could be implemented with effect from the commencement of reporting year 2012/3, provided the licence changes are implemented before the end of 2011.

Notwithstanding our view that changes are not justified, none of the other proposed amendments should in any event be implemented in advance of the start of the next round of price controls to allow for appropriate cost recovery to be put in place.

A further implementation constraint would apply in relation to the proposed new licence condition requiring the appointment of "sufficiently independent directors": at least 9 months notice would be needed from completion of the formal licence amendment process to allow for selection and appointment of suitable individuals. It would also seem appropriate to allow a minimum of 3 months notice from the conclusion of the formal licence amendment process for any of the proposed changes that are ultimately implemented, although given the nature of some of the proposed amendments (e.g. to the ultimate controller undertaking and availability of resources conditions) it would be clearer for all

the changes which are adopted only to take effect from the start of a reporting year (April to March) which commences after completion of the formal licence consultation process.

Lastly, if any of the changes were to be changed from those in the current consultation such that they could have any retrospective effect, a more extended notice period would be required.

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?

Considering each of the ring fence conditions where changes have been proposed in turn (and subject to our comments on the proposed drafting):

- Disposal of Assets: the proposal does not appear to address the risks in a proportionate way. Whilst the amendment proposed is a further restriction that could increase the unencumbered financial assets that are available in the event of financial distress, the same would equally be true of other unjustified measures that have not been proposed, and the benefit of extending the "Disposal of Assets" condition has not been quantified. In particular, the overlap with the existing "availability of resources" condition which is acknowledged at Paragraph 3.11 is not properly developed to assess whether the claimed benefits are in fact real or proportionate.
- Availability of Resources: given that the existing licence condition already requires licensees to act at all times in a manner calculated to secure the availability of resources, extending the adequacy of resources certificate to cover non-financial resources should not impose significant new burden on licensees (though it is correspondingly unclear what risk will be addressed or reduced by such an extension). We continue to have the view, as expressed in our April 2010 response, that it would be good practice for NWOs to have adequate records of key financial, operational and contractual information, and consequently the proposed requirement to maintain an "intervention plan" seems reasonable in principle.
- Undertaking from ultimate controller: although we do not see any need for the proposed change to this condition, because the board of the ultimate controller will remain conscious of the undertaking and its obligations, the proposed extensions to this condition do not appear unduly onerous.
- Indebtedness: the proposed extension of the "cash lock-up" provisions is not proportionate for the reasons expressed under "Additional cash lock-up triggers" in the main part of the covering letter above.
- Requirement for Sufficiently Independent Directors – see our comments in the main part of our response above, and the responses to Chapter 4 questions below.

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

Considering each of the ring fence conditions where changes have been proposed in turn:

- Disposal of Assets: the main comments made in relation to this proposed change appear to be acknowledged in the new consultation.
- Availability of Resources: our objections in principle to the proposed extensions to this licence condition (both extended certificate and requirement to maintain an intervention plan) are addressed through the proposed wording, and provided implementation of the proposed amendments is delayed until the commencement of the next round of price controls our remaining objections will also be addressed.
- Undertaking from ultimate controller: in the light of the responses to the initial consultation, the proposed amendment appears to be of little practical effect.
- Indebtedness: the previous responses to the March 2010 consultation included many objections to the proposed extension to the cash lock-up provisions. Whilst some of these have been addressed, in particular by limiting the new provisions only to "material" breaches of covenants,

some of the objections in principle have not been addressed (as explained in the section on cash lock-up triggers in the covering letter above).
- Requirement for Sufficiently Independent Directors – see our comments in the main part of our response above, and the responses to Chapter 4 questions below.

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?

Under the overall defence in depth approach adopted by Ofgem, the proposed changes are either of no beneficial effect or are unnecessary, and so will not make any material improvement to the existing arrangements which, as Ofgem have commented in the consultation, have worked effectively.

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

Considering each of the ring fence conditions where changes have been proposed in turn:

- Disposal of Assets: we note that Ofgem suggest that OFTOs are very different in nature from other networks and that as a result they may have chosen particular financial arrangements which are not available to other networks and could be incompatible with the proposed restriction. We recognise that this could form a justification for an exemption for OFTOs from this new restriction (if implemented).
- Availability of Resources: consistent with Paragraph 3.21, we do not see any need for any particular class of NWO to be exempt from the proposed changes to this licence condition if they are implemented.
- Undertaking from ultimate controller: if the amendment is to be introduced, we can see no strong reasons why exemptions should be applied to certain categories of licensee.
- Indebtedness: if the amendment is to be introduced, we can see no strong reasons why exemptions should be applied to certain categories of licensee.
- Requirement for Sufficiently Independent Directors – see our comments in the main part of our response above, and the responses to Chapter 4 questions below.

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

Without prejudice to our comments above, we have a number of comments on the specific drafting provided by Ofgem. As such, this section should be read in conjunction with the mark-up of the specific conditions applicable to National Grid which we have provided with this response. Generally, we note that the proposed conditions have not been drafted consistently among themselves. So, for example, the cross references at paragraph 5 of the proposed draft of Condition B3 of electricity transmission licences (a reference to paragraph 1 only) is not consistent with the cross references made in the equivalent paragraph of Standard Special Condition A27 of gas transporter licences.

We have provided a scanned mark up of comments to be read alongside this consultation response. However, we would also make the following specific comments:

<u>Disposal of assets condition</u>
It is not clear what the words “serve to” proposed for inclusion in, for example, paragraph 3 of Standard Special Condition A27 of gas transporter licences means. We consider that it would be clearer to say “will not have the effect of extending” instead of “does not serve to extend”.

The changes proposed to paragraph 8 of Standard Special Condition A27 of gas transporter licences are not relevant to the consultation, and do not, in any event, improve the clarity of this paragraph. As such, they should not be taken forward.

Availability of Resources

Again, the issue of inconsistency is apparent in the drafting of the various certificates. For example it is not clear why, in part (ii) of Certificates 1 and 2, assurance is to be given in respect of "the transportation business" whereas in part (i) of the certificate, the assurance is given in relation to "the activities authorised by the licence(s) held in accordance with its obligations under the Act and such licence(s)".

Furthermore, in the draft of Standard Special Condition A37, paragraph 8 MUST be left as "NOT USED" as this paragraph was specifically left open to allow for the text that is "pasted in" to this condition by Special Condition C1 (Amendments to Standard Special Conditions relating to LNG) in NGG's GT licence in respect of the NTS.

Ultimate Controller Obligation

In paragraph 3, there is no need to refer to "relevant" years as this notion is only needed for the revenue restriction provisions – "year" or "financial year" (defined in the definitions condition) would be better and remove the need to create a new defined term.

The word "extant" does not seem to be appropriate in the context of plain English drafting – the words "the undertakings ….. in force at that time" or similar would be better. Similarly, "re-apprising" would be better replaced by "reminding".

Indebtedness

We consider that the phrase "covenant pertaining to its financial affairs", which has been used in the proposed additions to the licence conditions, is neither clear, nor in plain English. It would be better if words such as "covenant contained in any loan agreement, commercial paper, bond issue or committed facility" were used instead.

Additional Question (Paragraph 3.30): we do not think it would be right for availability of resources certificates to be placed in the public domain, for reasons of commercial confidentiality and because of the risk of unintended consequences. Licensees already have requirements to publish information in various ways, including the requirements to publish regulatory accounts, and Ofgem publish annual summaries of regulatory reporting submissions from licensees. If in the future Ofgem were to identify particular deficiencies in the information that is currently publicly available on licensees, these requirements could easily be added to an existing set of reporting requirements such as those which specify the regulatory accounts, rather than publishing compliance certificates or statements submitted in compliance with ring fence conditions which are not designed for public disclosure.

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?

We do not think the proposal is proportionate or appropriate – please see our covering letter and the executive summary and independent directors sections in particular.

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?

The proposal obviously addresses the concerns that would relate specifically to a requirement for a majority of independent directors, but fails to address the concerns that have previously been expressed by National Grid and others regarding the proposal to introduce a requirement for a minority of independent directors (see our response of November 2010 as well as that from April 2010).

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

Whilst we do not accept that the proposed requirement for two SIDs is proportionate or justified for any licensee, if Ofgem were to introduce such a licence requirement for some companies we continue to believe that the requirement should not apply where the Ultimate Controller of the NWO is a listed company subject to the UK Corporate Governance Code, as explained in our covering letter above and in our letter of November 2010. This earlier letter also explained how the licence drafting could be changed to give effect to such an exception.

As indicated above, licensees already have a requirement to comment on compliance with the UK Corporate Governance Code as part of their regulatory accounts. This should provide sufficient assurance to Ofgem that the independent directors at the ultimate controller level are providing appropriate oversight of the NWO.

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

We have provided a scanned mark up of comments to be read alongside this consultation response. However, we would also make the following specific comments:

- In paragraph 8, the word "less" should be replaced by "fewer" as directors are individuals, not an indivisible mass.
- In paragraph 9, clarity would be improved by changing the last line to "that single entity".

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?

Notwithstanding that we don't agree with the requirement, if it was to be introduced we suggest there should be at least a 9 month lead-time to allow suitable candidates to 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?

Notwithstanding that we don't agree that the requirement for SIDs should apply to <u>any</u> Licencees, if this proposal were to proceed it is not clear why IGTs and IDNOs should not be subject to the requirements of the proposals (including independent directors), since consumers connected to their networks are no more able to choose their network operator than anyone else, nor are they at any less risk of their service provision being affected by the collapse of a network operator than any other consumer: for example, if an IGT collapses, who will pay for the provision of an emergency service? It cannot be assumed that the "local" IDN should be required to do this without recompense and, indeed, at present it is neither obliged nor funded to do so.

Additional Consultation Questions: Paragraph 4.44/4.45 raises the following additional questions:

- "*We would be especially interested to receive comments on how effective a requirement for SIDs (or the alterative 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 investigations";* and
- "*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."*

In response to the first of these questions, please see our comments in the main part of our response above.

In response to the second of these questions, additional audit requirements would be difficult to specify and would be of limited value given that licensee directors already take great care in approving dividends and in the preparation of pre-dividend certificates (as required under existing licence

conditions). In the light of this, the limited benefit from additional audit requirements would not justify their cost, particularly when an administrator would be able to claw back any improperly paid dividends paid prior to the insolvency.