

Scottish Power Energy Networks Holdings Limited (“SPEN”)

Response by Scottish Power Energy Networks Holdings Limited on behalf of SP Distribution Limited, SP Manweb plc and SP Transmission Limited (‘ the Licence Holders’) to the Consultation in relation to ‘Proposed Modification to the ‘Ring Fence’ Conditions in Network Operator Licences’

The Licence Holders welcome the opportunity to comment on the consultation and impact assessment ‘Proposed modification to the ‘Ring Fence’ Conditions in Network Operator Licences’ impact assessment and consultation issued by Ofgem on the 25 March 2011.

Overview

We fear that in the interests of being seen to act, Ofgem has put itself under pressure to add to the current regulatory requirements of the regional distribution/transmission network licensees. We consider that this will result in unnecessary further bureaucracy that ultimately will impose further cost on the consumer without adding to the strength of the financial ring-fence.

SPEN remains of the view that the recent global economic conditions ensuing from the collapse of the banking sector have not given rise to any outcomes that would suggest further strengthening of the regulatory ring fence in Electricity or Gas is necessary or is required.

Ofgem has in existence a rigorous set of requirements which are reviewed annually and hold statutorily, sufficient powers to also obtain whatever information they should require in the event that such circumstances are suspected.

Scottish Power Corporate structure

The Licence Holders each have a board of directors consisting of individuals who are separate from the liberalised business of the Scottish Power group.

Further, since December 2010, the Licence Holders have been involved in work to reinforce the robust group governance objectives through the creation of two new holding company boards; one relating to the liberalised business and the other relating to the regulated business; Scottish Power Energy Networks Holdings Limited (‘Scottish Power Energy Networks’).

The Board of Directors of Scottish Power Energy Networks is responsible for the effective day to day operation of the regulated business within the Scottish Power group and consists of directors who have no relationship with the liberalised business. This reinforces the very clear business separation of the networks business, from liberalised activities. I attach a copy of a letter dated 28th February 2011 to Andrew Wright and Stuart Cook from Marion Venman, our Head of Legal and a letter Pamela Taylor dated 16 March 2011 in which we emphasise this further layer of

governance in the context of unbundling but which applies equally in relation to the ringfence proposals.

It should be noted that the Board of Directors of Scottish Power Limited (the ultimate UK parent company) includes 3 non executive, independent directors.

We believe Ofgem's focus should be to continue to develop the close correlation of shareholder and consumer objectives which current price controls ensure. This is a greatly superior catalyst to protecting consumers, from the potential financial distress of network operators, and does not amount to additional inefficient regulation.

Scottish Power Energy Network's position of strong opposition to the introduction of Sufficiently Independent Directors ("SIDs") as outlined in earlier consultation responses is unchanged.

Scottish Power Energy Networks welcomes the acknowledgement from Ofgem that the initial proposal for a majority of independent directors would have seriously interfered with shareholders' rights of control.

We hold the view that neither a convincing nor a conclusive argument exists that the introduction of SIDs will introduce greater protection to customers. The doubts raised by Ofgem's consultants, CEPA, in their October 2009 'Assessment of Ofgem's financial ring fence conditions' relating to the duties of non executive directors being the same as those of executive directors have not been addressed to our satisfaction in the consultation.

In short, Scottish Power Energy Networks considers that the introduction of SIDs is (i) unnecessary due to the existing robust governance, licence and statutory regime and (ii) too onerous in terms of excluding a large section of potential candidates including existing independent non-executive directors.

Sufficiently Independent Directors ("SIDs")

Whilst the right decision was made by Ofgem to remove the requirement for a majority of independent directors, Scottish Power Energy Networks considers that the requirement for independent board representation should have been removed in its entirety. Ofgem has failed to give due recognition of the legally enforceable ultimate controller undertaking under (electricity) distribution licence condition 31 and transmission condition B8. This undertaking by the 'ultimate controller' that it will not take any action that is likely to lead to a breach of the relevant licences provides considerable greater comfort to customers than the presence of SIDs.

We believe the importance of the ultimate controller undertaking has been underplayed and there is no evidence, of which we are aware, which suggests that NWOs have not been mindful of this licence condition.

We do not consider that the comments included by Ofgem addresses the important considerations regarding the doubts raised by CEPA regarding whether the addition of non-executive directors would further enhance the ring fence provisions.

We concur with CEPA that the duties of executive and non-executive directors are to promote the success of a company for the benefit of its members which is not consistent with Ofgem's intention of and main arguments proposed in favour of SIDs.

Individually each item raised in the consultation in support of SIDs is tenuous and no conclusive arguments have been presented which convinces Scottish Power Energy Networks that the additional cost is in the best interests of customers. An example of this is the inciting suggestion in paragraph 4.7 relating to the possibility of public funds having to be committed in the event a NWO had to enter special administration. In the event of sufficient financial pressures, the logical route, with the least risk to existing shareholder's wealth, would be to exit an investment, in a NWO, through a managed sale.

Recent corporate transactions relating to NWOs indicate an international appetite to invest in the UK making a divestment, if a shareholder experiences financial distress, a highly possible transaction. The odds on a managed sale of a NWO by a shareholder, experiencing financial distress, is infinitely more likely than the need for public funds being committed to support an NWO.

It is relevant to note that Ofgem has a legal duty to have regard to the ability of the licensees to finance their regulated activities when setting price controls and revenues.

Ofgem refer to the considerable importance attached to the influence of good corporate governance at group level. We believe simple, more cost effective measures could be introduced as an alternative to introduction of SIDs at licensee level. To address the benefits of SIDs that Ofgem identify in paragraph 4.43 the following two actions could be introduced:

- Group non-executive directors could be requested to provide written confirmation annually to acknowledge and confirm their appreciation of the NWOs protect energy company status.
- Group non-executive directors could joint sign annual availability of resource certificate with a director of the licensee.

Directors responsibilities under UK legislation

Scottish Power Energy Networks considers that insufficient consideration has been given to the extensive obligations imposed by the Companies Act 2006 on directors which are consistent with the ring fence provisions particularly with the Availability of Resource Certification. Objective consideration of these obligations mitigates the need for SIDs and offers significant comfort in relation to Ofgem's concerns on NWO

failure. For example the directors are required by law to prepare financial statements which provide a true and fair view, of the state of affairs, of the company and make an assessment on the appropriateness of a going concern basis.

Wider regulatory environment of regional network companies

As noted in our previous response, the existing regulatory framework provides strong financial incentives for network companies to strive to meet the terms of their regulatory settlements and their legal duties and obligations relating to providing reliable, secure and safe networks.

In addition it is necessary to take into account the remaining regulatory submissions made by regional network licence holders, including audited regulatory accounts, substantial regulatory cost reporting submissions (Regulatory Reporting Pack (RRP)) as well as non financial data covering the quality of service. These existing submissions provide a wide range of evidence which should allow Ofgem to identify any symptoms of under investment or a lack of maintenance in the network. It would seem more appropriate to develop any additional controls using the substantial information that is already produced.

The Distribution Price control 5 (DPCR5), for the period 1 April 2010 to March 2015, requires extensive annual reporting of outputs in relation to all aspects of asset maintenance, and replacement. The reporting includes the volume and value of expenditure. Ofgem has also introduced a new financial mechanism as part of the DPCR5 agreement which places a financial penalty upon distribution network operators that are not meeting their agreed investment outputs.

Ofgem has not given adequate lateral consideration and joined up consideration of the regulatory economic tools available to address concerns on NWO financial health. The correlation of shareholder and consumer objectives, which current price controls ensure, provides far greater protection to consumers than the introduction of SIDs could achieve. The focus should be on encouraging behaviours in customers interests through opportunities to enhance shareholder return rather than imposing an additional regulatory burden and potential disincentives to invest in NWOs.

Other Regulatory tools

Given the many incentives and penalty mechanisms included in the price control reviews of the NWOs it is highly unlikely that shareholders of an NWO would impair their wealth, through insufficient investment, resulting in lower customer service and in the event that the shareholder of a regional network company was not in a financial position to invest sufficiently (which will more generally reflect the insufficiency of the rate of return) the decision to exit the investment through a managed sale would be the logical route with the least risk to existing shareholder's wealth.

Conclusion

We are supportive of the proposed modifications to ring fence conditions with the exception of the proposed introduction of Sufficiently Independent Directors.

As detailed above we consider that there are significantly more effective regulatory tools available to Ofgem to encourage behaviours in customers' interests. The catalyst to protecting consumers, from the potential financial distress of network operators, is not additional costly regulation but to ensure the regulatory environment continues to ensure the close correlation of shareholder and consumer objectives.

We believe the concerns raised by CEPA in relating to directors duty to shareholders have not been adequately addressed and significantly undermine the arguments Ofgem have presented in favour of SIDs.

We have proposed controls that could be introduced that address the believed benefits SIDs bring over a strong group non-executive oversight.