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Dear Paul

Proposed modifications to the 'Ring Fence' conditions in Network Operator Licences

SSE and SGN welcome the opportunity to respond to Ofgem's recent consultation regarding proposed modifications to the ring fence conditions. Please note that, in terms of the proposed legal drafting, we support the joint response from network operators.

Our response focuses in the main on the proposal to require a minimum of two independent directors on licensees' boards as this remains a significant concern for us. As explained in previous responses, we believe that this constitutes a fundamental and unnecessary shift in the operation and governance of our network businesses. This change, if implemented, has the potential to significantly reduce, and even remove, the control that we have over the efficient operation of them. For the avoidance of doubt, we remain strongly opposed to this proposal and would reject any licence condition that sought to implement it. We believe that both the alternative proposals that have been put forward by network operators (NWOs) provide a more proportionate and reasonable solution to the perceived risk that non-independent directors may put the interests of the parent company ahead of those of the network business itself. We discuss these proposals further below.

Comments made here are in addition to our 23 April 2010 response.

Background

Both SSE and SGN have supported Ofgem's work over the past two years to test the ability of the existing ring fence conditions in NWO licences to manage the risk that financial distress could adversely affect NWOs. Given global financial events and changes to the ownership and operational structures of some networks, this was a timely exercise. An important consideration in this work, as Ofgem has observed, is that all of the NWOs have come through the recent financial crisis without any significant issues.

Notwithstanding the lack of evidence that the existing provisions are in any way ineffective, and to the contrary the strong evidence to demonstrate that the provisions are indeed highly effective, Ofgem has concluded that there is a need to significantly strengthen the ring fence conditions. Given this lack of evidence; Ofgem's failure to take into account stakeholder responses; and inconsistencies in Ofgem's consultation, we are concerned that Ofgem has not made the case in deciding on its latest proposals.

The case for changing the ring fence conditions

Ofgem's case appears to be based on four risks for which no evidence has been provided and that we consider are very unlikely to occur. The proposed changes to the ring fence conditions are therefore disproportionate and, further, we are not clear how these relate to the perceived risks.

In respect of responses to the March 2010 consultation, we note Ofgem's statement that:

"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 are also some concerns about the risk of unintended consequences."

All of the respondents to the initial consultation, including SSE and SGN, expressed concern about the validity of Ofgem's conclusions. While NWOs were supportive of the role of the current ring fence conditions in providing certainty within the regulatory regime, they did not believe that the case for change had been made. Indeed many commented that change without a clear purpose had the potential to undermine the value of the ring fence provisions. Many respondents raised specific questions and issues about the proposals to modify NWO licences; in particular the potential perverse consequences of ill-defined changes to the cash lock up provisions, and the disproportionate regulatory interference of a licence condition that prescribes the structure of NWOs' Boards.

Despite this clear message from respondents, Ofgem appears to be continuing to push forward with the proposals, with very little change from those proposed in the original consultation and without addressing many of the issues raised.

Particularly on the point of independent directors, Ofgem notes that “nearly all respondents were against our proposed requirement for a majority of independent directors of NWO boards”. In addition to this, several respondents were strongly opposed to a requirement for a minimum number of independent directors on NWO boards. Ofgem’s proposal to require a minimum of two independent directors does not appear to address the issues raised by respondents, or to seriously consider the two alternative proposals that have been submitted.

Important elements of any proposed licence modification are the objectives and reasons for the change. However, with regard to the independent directors proposal in particular, we note that a number of the statements that Ofgem has made, and a number of factors that are said to have been taken into account, do not appear to be consistent.

For example, we note Ofgem’s comment that: “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”. We agree with this statement and yet it appears to be entirely at odds with Ofgem’s proposal to introduce a mandated board structure.

Further, we note that Ofgem claims that the proposals have sought to: “minimise interference with the direction or management of network businesses and legitimate influence from business owners”; and “acknowledge that diversity in ownership and corporate structures can be beneficial for consumers”. Again, whilst we wholly agree with these comments, Ofgem’s proposal appears to dismiss these fundamental principles.

Further, the consultation states that Ofgem sought to allay concerns raised at the industry workshop by clarifying that: “our proposals in respect of independent directors are not intended to impinge on legitimate control of NWO businesses by their owners”. However, by altering the composition of NWOs’ boards and restricting the pool of directors from which we can choose, this is exactly the effect that the proposals will have.

In summary, it is clear that the case for change to the existing licence modifications has not been made and that several of the points made by Ofgem in justification are contradictory and unclear. The proposed modifications therefore represent disproportionate regulatory intervention in an area which has been recently rigorously tested and found to be fit for purpose.

Sufficiently Independent Directors: Alternative proposals

Two alternative proposals to Ofgem’s independent directors proposal have been put forward by network operators. Whilst the consultation does not appear to fully consider nor to recognise the merits of these proposals, we consider that both of the alternative approaches provide a more proportionate and reasonable solution to Ofgem’s perceived risk.

Ofgem perceives there to be a risk that in a period of financial distress, non-independent directors may put the interests of the parent company ahead of those of the NWO. However there is no evidence to suggest that Ofgem's proposal to introduce a requirement for a minimum of two independent directors would address this perceived risk, particularly as independent directors would have the same duties under the Companies Act 2006 as other NWO directors. Certainly during the recent economic crisis the presence of independent directors did not prevent several banks from experiencing serious financial distress. Indeed in a report commissioned by Ofgem, CEPA notes that: "We have doubts that the additional non-executive board members are likely to have a significant impact".

On the other hand, both of the alternatives tabled offer solutions that would address Ofgem's perceived risk.

On the proposal to require an independent auditor report on pre-dividend certificates, we note Ofgem's comment that this "would only address one particular risk and would be characteristic of a more interventional regulatory approach which is not favoured". We are not clear what risk Ofgem is looking to address if not that of inappropriate payments being made from the NWO to the parent company. Further, we are surprised that Ofgem considers this to be a more interventional regulatory approach than the independent directors proposal. In terms of the impact on our businesses, the introduction of a mandated board structure is far more interventional.

On the proposition to place greater reliance on corporate governance at group level, this enhancement of existing arrangements is a far more reasonable approach that avoids intervention in our board structures whilst still addressing Ofgem's fundamental concern.

We note that one of the benefits that Ofgem considers independent directors would bring that this proposal would not is: "an unconflicted voice of reason with respect to the interests of the licensed NWO business at times of operational or financial distress". This statement is misleading, as non-independent directors would be required by law to avoid actual or potential conflicts of interest with the company. These duties are understood and taken very seriously by our directors.

Sufficiently Independent Directors: Good corporate governance

Notwithstanding the views given above regarding Ofgem's process and the case for change, we also have fundamental concerns regarding the proposal itself and believe that it sets a dangerous precedent in terms of governance. Although some of these concerns are raised in the consultation, the majority, for example the precedent set by the presence of non-executive directors, are not addressed.

All directors are subject to the same legal requirements. Our current board members are subject to the same ring fence conditions in the licence and detailed duties set out in the

Companies Act 2006 as any independent board member would be. Given that the makeup of the board does not change the directors' duties, it is difficult to see that there would be any benefit in mandating a board structure that incorporated independent directors.

By pre-determining criteria that certain board members will be required to meet, Ofgem is in our view interfering inappropriately with the existing governance arrangements under both the Companies Act 2006 and the UK Corporate Governance Code.

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

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

Other proposals

Regarding the remainder of Ofgem's proposed modifications to the ring fence conditions, we are similarly not clear that these address any real risks or add any value. However, whilst they will introduce some limited restrictions on the management and operation of our businesses, they will not significantly interfere with our responsibilities under the ring fence conditions and will mostly constitute additional regulatory burden. We are therefore not strongly opposed to these changes.

If you would like to discuss any of this further, please be in touch.

Yours sincerely,

Aileen McLeod
Head of Regulation, Networks