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Dear Rachel,

Proposed Modification to the 'Ring Fence' Conditions in Network Operator Licenses

This document sets out the response by Wales & West Utilities to the consultation 'Proposed Modifications to Ring Fence Conditions in Network Operator Licenses' published by Ofgem in March 2011.

It is our view that any changes made should be viewed in the context that the ring fence arrangements have worked well since they were put in place during the 1990's. The success of the arrangements was, in part, demonstrated by the fact that Network Operators emerged relatively unscathed from the recent financial crisis.

Finance providers and Rating Agencies attach considerable importance to the ring fence regime and it is appropriate that the regulator should periodically re-visit the appropriateness of these arrangements. WWU welcome this approach provided that the costs of any additional measures do not outweigh the perceived benefits.

The specific change that we would encourage Ofgem to give careful consideration to is the proposed new ring-fence condition requiring two Sufficiently Independent Directors (SID's). We welcome the response by Ofgem to the concerns raised over the initial proposal for a majority of independent directors and we are happy with the proposed suggestion of two independents, which is consistent with our normal board composition. However, we would encourage Ofgem to reconsider the criteria for a Sufficiently Independent Director, which we currently regard as unnecessarily onerous and may in certain circumstances be detrimental to the governance process.

In Section 4.2 of the consultation, Ofgem set out the proposed criteria for Sufficiently Independent Directors in order to establish the right degree of independence. The need for independence is fully recognised and further we note that Network Operators and the Sufficiently Independent Directors (under a condition of appointment) would be required to use their best endeavours to ensure that the appointee remained sufficiently independent during their term of service.

However, as discussed below we feel that the requirement that a Sufficiently Independent Director must not be a director of an 'affiliate or related undertaking' is too prescriptive for the legitimate concern it is looking to address and the requirement to have separate directors for the operating company will lead to unnecessary costs and administration for the licensee group as a whole.

Additionally, the requirement that a Sufficiently Independent Director must not be a director of an 'affiliate or related undertaking' is more onerous than that imposed by other regulators e.g. Ofwat.

Considering the specific case of WWU, there are three categories of companies that would be regarded as an affiliate or related undertaking;

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Wales & West Utilities Limited
Registered Office:
Wales & West House, Spooner Close, Coedkernew, Newport NP10 8FZ
Registered in England and Wales: No. 5046791

* See Appendix B for the full group structure

- **Holding Companies**

MGN Gas Networks (UK) Limited, MGN Gas Networks (Junior Finance) Limited, MGN Gas Networks (Senior Finance) Limited and Wales & West Utilities (Holdings) Limited are all non-trading holding companies of WWU.

- **Finance Companies**

Similarly to other Network Operators, WWU have a wholly owned special purpose subsidiary (Wales & West Utilities Finance plc) providing long term funding for the activities of its immediate parent company, WWU.

- **Shareholders in the Ultimate Parent Company**

Shareholder companies holding an equity investment in the top group company – MGN Gas Networks (UK) Ltd and therefore indirectly in WWU.

To consider these companies in turn, we do not accept that a conflict would arise in respect of the duties of an independent director in the case of companies falling into the category of holding or finance companies, where this is the sole purpose of those entities. Contrary to the arguments presented in Section 4.6 of the consultation, we feel strongly that it gives additional protection to the licensee that the other companies in the group have Sufficiently Independent Directors exercising their independent judgement. It could present significant risk to the licensee if its financing company or holding company did not benefit from the good governance and 'voice of reason' at board meetings in relation to the group as a whole.

Potentially, as an extra measure, holding companies could be asked to give an undertaking to the licensee that it will not carry out any trade or other activities that could lead to the existing independence of the Sufficiently Independent Directors being prejudiced.

Additionally, if the proposed changes are to be made, the requirements for a Sufficiently Independent Director will need to have the appropriate transitional arrangements. As drafted, the existing independent chair of WWU would cease to be eligible for 12 months as he currently holds this role in the holding and financing companies within the group.

The potential tension between being a director of a Network Operator and an employee/director a shareholder company is understood, particularly if the group's business were experiencing financial distress.

We would also re-iterate the costs involved to a licensee company from having Independent Directors, which if required, should be recognised appropriately in the cost allowances determined as part of RIIO-GD1

Our responses to the specific questions within the consultation are outlined in Appendix A of this response.

Yours sincerely,



Steve Edwards

Head of Commercial and Regulation

Wales & West Utilities

Appendix A – Responses to consultation questions

Chapter 1

Q1 Have we identified the risks and concerns which are important to you?

The ring fence arrangements have worked well since they were put in place during the 1990's. The success of the arrangements was, in part, demonstrated by the fact that Network Operators emerged relatively unscathed from the recent financial crisis.

Finance providers and Rating Agencies attach considerable importance to the ring fence regime and it is appropriate that the regulator should periodically re-visit the appropriateness of these arrangements. However, Ofgem should recognise the additional costs both financial and in terms of compliance effort and should ensure that the envisaged benefits outweigh the costs involved.

Q2 Do you think that any of our proposals will require deferred start dates to allow NWO's to make preparation for compliance?

The required timescales will be determined by the package of proposals that are ultimately agreed. However, there are two areas that it is immediately apparent that an appropriate time period should be allowed.

a) Sufficiently Independent Directors (SID's)

The proposed changes to Board composition may require certain Network Operators to source additional Sufficiently Independent Directors. As Ofgem will recognise, there are a relatively small group of individuals available with the relevant skills and experience and a search for the correct appointees can take a number of months.

Further, if the proposed changes are to be made, the requirements for a Sufficiently Independent Director will need to have the appropriate transitional arrangements. As drafted, the existing independent chair of WWU would cease to be eligible as a Sufficiently Independent Director for 12 months as he currently holds this role in the holding and financing companies within the group.

b) Availability of Resources – Intervention Plan

Whilst licensees will have the majority of information readily available, the production of an appropriately documented and catalogued final plan will still require significant resource. Ofgem should ensure that appropriate time period is given for this exercise to be completed.

Chapter 3

Modifications to Existing Ring Fence Conditions

Our responses to the four suggested changes to the existing conditions are set-out below

a) Disposal and Charges over assets

The restriction on the granting of security interests should be extended to cover the NWO's receivables.

The key matter in our response is that highlighted in Clause 3.14 of the consultation. It would be disproportionate to expect a Network Operator to revisit existing charges that form part of the security package made available to lenders and therefore any changes made cannot be retrospective. In the situation where a Network Operator has granted such security over its receivables, any adverse amendment to the security package could restrict financing options and have an adverse impact on cost of debt.

Ofgem note in Section 3.6 that existing charges can remain in effect and be varied as long as the scope is not materially extended. For the avoidance of doubt, the restriction on 'material extension' should relate to the nature of the security being extended. Where a Network Operator is issuing bonds out of an established programme, it is necessary for new lenders to accede to the common security arrangements held by existing lenders in order for the debt to rank *pari passu*. This is common practice and essential as part of a financing package, we therefore do not believe that the 'material extension' language was intended to restrict this, but would welcome clarity of understanding on this point.

b) Availability of Resources

The annual certification requirement should be extended to cover operational/business resources.

The extension to the annual certificate is agreed as appropriate and is consistent with the license condition. A licensee is already required to consider the availability of all financial and operational resources required to carry on the network business.

NWO's should be required to maintain an Intervention Plan providing key financial and operational information.

It is worth noting that a Network Operator will be maintaining records of this nature as part of their disaster recovery planning. The request is considered appropriate provided that:

- Clear guidance is given as to what the plan should contain.
- The plan is kept as simple as possible to avoid the requirements becoming unduly onerous.
- An appropriate time period is given by Ofgem for the initial plan to be completed.

Within Section 3.30 of the consultation, we are asked to comment on the suggestion that A37 certificates are placed in the public domain. We feel that public communication of its financial affairs to should be left to the discretion of the licensee board.

c) Ultimate Controller Undertaking

In addition to existing requirements, each NWO should, by 31 July each year:

- **Provide Ofgem with a list of its ultimate controllers, and**
- **Confirm that it has sent a letter to each of these ultimate controllers re-appraising them of their responsibilities under their undertakings.**

We recognise that the proposal could be of benefit, particularly in circumstances where there are changes of management within the ultimate controller

d) Restriction of Indebtedness

Addition of two more categories of trigger event to the 'cash lock-up' mechanism.

- **Adverse Availability of Resources submission**
- **Breach of a financial covenant**

The arguments for the additional trigger events are understood and agreed with. However, our agreement would be on the provision that the criteria for the release of the lock-up are as documented in sections 3.47 and 3.48 respectively of the consultation.

In the case of the former, the trigger event could be remedied simply by a positive submission, which could be done by the board at any subsequent time - the board would not have to wait until the next scheduled certificate submission.

In the case of a financial covenant, the key evidence is that the breach has been remedied, or the covenant renegotiated to the satisfaction of the counterparty (and notified in writing).

Chapter 4

Sufficiently Independent Directors

Q1 Do you think our revised proposal to require NWO's to have two Sufficiently Independent Directors (SID's) is proportionate and addresses the risks we have identified particularly in relation to possible conflicts of interest?

In common with a number of Network Operators, we felt that the original proposal for a majority of Sufficiently Independent Directors was disproportionate in relation to the risks referred to and would have impacted on the legitimate ability of shareholders to influence and direct the management of Network Operators. We welcome the acknowledgement of these concerns and would consider the requirement for two Sufficiently Independent Directors to be a more appropriate board composition.

We broadly acknowledge the rationale behind the appointment of Sufficiently Independent Directors and the criteria that Ofgem have adopted in respect of their skills, knowledge, experience and personal qualities.

In Section 4.2 of the consultation, Ofgem set out the proposed criteria for Sufficiently Independent Directors in order to establish the right degree of independence. The need for independence is fully recognised and further we note that Network Operator and the Sufficiently Independent Director (under a condition of appointment) would be required to use their best endeavours to ensure that the appointee remained sufficiently independent during their term of service.

However, the area that we have significant concerns about is the requirement that a Sufficiently Independent Director must not be a director of an 'affiliate or related undertaking'. As explained below, we will feel this drafting is currently too prescriptive for the legitimate concern it is looking to address and the requirement to have separate directors for the operating company will lead to unnecessary costs and administration for the licensee group as a whole.

Additionally, the requirement that a Sufficiently Independent Director must not be a director of an 'affiliate or related undertaking' is more onerous than that imposed by other regulators e.g. Ofwat.

Considering the specific case of WWU, there are three categories of companies that would be regarded as an affiliate or related undertaking;

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To consider these companies in turn, we do not accept that a conflict would arise in respect of the duties of an independent director in the case of companies falling into the category of holding or finance companies, where this is the sole purpose of those entities. Contrary to the arguments presented in Section 4.6 of the consultation, we feel strongly that it gives additional protection to the licensee that the other companies in the group have Sufficiently Independent Directors exercising their independent judgement. It could present significant risk to the licensee if its financing company or holding company did not benefit from the good governance and 'voice of reason' at board meetings in relation to the group as a whole.

Additionally, if the proposed changes are to be made, the requirements for a Sufficiently Independent Director will need to have the appropriate transitional arrangements. As drafted, the existing independent chair of WWU would cease to be eligible for 12 months as he currently holds this role in the holding and financing companies within the group.

The potential tension between being a director of a Network Operator and an employee/director a shareholder company is clear, particularly if the group's business were experiencing financial distress.

Q2 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?

As stated in Q1, we felt that the original proposal for a majority of Sufficiently Independent Directors was disproportionate in relation to the risks referred to and would have impacted on the legitimate ability of shareholders to influence and direct the management of a Network Operator. We welcome the acknowledgement of these concerns and would consider the requirement for two Sufficiently Independent Directors to be a more appropriate board composition.

Q3 Do you have any comments on the alternative approaches which we referred to?

Subject to the comments raised in Q1 above, we consider the Sufficiently Independent Director approach to be the most appropriate

Q4 Is our drafting condition for sufficiently independent directors clear and concise, or could the drafting be improved?

We have sought guidance directly as to the intended definition of 'affiliate'. We feel that it would be appropriate for Ofgem to publish this definition in due course to ensure clarity of understanding.

Q5 If a requirement for SID's is introduced, how much lead time do you think should be allowed for candidates to be selected and appointed?

The proposed changes to Board composition will require certain licensees to recruit additional Sufficiently Independent Directors. As Ofgem will recognise, there are a relatively small group of individuals available with the relevant skills and experience and a search for the correct appointees can take a number of months. We therefore consider that a period of 6 months would be an appropriate period of transition to make the requisite changes to its board composition.

Further, the license drafting should contain the appropriate provisions for unforeseen exceptional circumstances that could arise (e.g. Short notice retirement, resignation or death of a director)