

Changes to the Ring Fence Conditions in Network Operator Licences

Position Paper

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Overview:

The Ring Fence Conditions in gas and electricity network operator licences provide assurance that network operators always have the financial and operational resources necessary to fulfil their obligations under legislation and their licences. This document sets out the position of the Gas and Electricity Markets Authority on prospective changes to five existing licence conditions (across several licence types) and on a proposed new condition relating to board composition for some licensees.

The proposed changes are intended to ensure that the Ring Fence continues to play an effective role in safeguarding the investments in energy infrastructure which are financed by consumers through their gas and electricity bills. They reflect the changing opportunities and risks faced by network licensees, their status as "Protected Energy Companies" and the essential nature of the infrastructure which they own and operate. The proposals in this document have been informed and influenced by the responses received to our earlier consultations, which were of a high quality and addressed both policy and drafting aspects.

This paper provides licensees and other stakeholders with an opportunity to comment on the updated draft licence modifications which have been developed following the consultation exercise which took place in 2011. Having considered any responses, we currently expect to issue statutory licence modification proposals during September 2012.

Context

Our principal objective is to protect the interests of existing and future energy consumers. Gas and electricity networks form a vital part of the infrastructure in Great Britain and since 2009 we have been updating the policies and procedures in place to manage the risk that a network operator could be affected by financial distress. This work has been carried out against the backdrop of ongoing economic concerns in Europe and elsewhere.

We have published two consultations (in March 2010 and March 2011) on updates and improvements to the suite of ring fence conditions in gas and electricity network licences. These conditions form an important part of the regulatory framework for managing risks associated with financial distress because they are intended to ensure that network operators always have the financial and operational resources necessary to fulfil their obligations under legislation and their licences. In October 2011 the Authority decided that we should proceed with a package of proposed modifications to the ring fence conditions and this document sets out the revised modifications which we currently expect to formally propose in the autumn of 2012. This is an opportunity for licensees and other stakeholders to comment on the developed drafting approach and to raise any new factors which they consider should be taken into account.

We have shown the prospective licence modifications as marked-up changes to the existing conditions in supplementary appendices 4 to 8 to this document. This presentation is, however, without prejudice to the Authority's consideration of responses to this document or to a statutory consultation on licence modifications.

Associated documents

- a) [Ofgem website page with Initial Impact Assessment/Consultation \(Ref 30/10\), CEPA report to Ofgem \(October 2009\) and published stakeholder responses](#)

<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=268&refer=Networks/Policy>

- b) [Ofgem website page with Consultation on Proposed Modifications to the Ring Fence Conditions \(Ref 42/11\) and published stakeholder responses](#)

<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=268&refer=Networks/Policy>

- c) [Minutes of Gas and Electricity Market Authority meeting – 13 October 2011](#)

<http://www.ofgem.gov.uk/About%20us/Authority/AuthorityMinutes/Documents1/Authority-Minutes-October%202011.pdf>

- d) [Regulatory Ringfence Update letter dated 13 March 2012](#)

<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=367&refer=Networks/Policy>

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Executive Summary

Energy network operators (NWOs) own and operate the essential infrastructure which transports gas and electricity from producers and generators to domestic and commercial consumers throughout Great Britain.

Since the mid 1990s NWO licences have contained a suite of 'ring fence' conditions which have helped to manage the risk that a gas or electricity network business could be affected by financial distress.

We now consider it is necessary to make focussed improvements to the ring fence regime in light of changing business structures and the emergence of new financial and operational risks. Our proposed licence modifications should ensure that the regulatory ring fence remains fit for purpose for years to come. A concise summary of our proposed changes is provided at Appendix 1 below and a full set of draft modifications is set out in the separate appendices document.

During the last two years we have carried out two consultations on possible changes to the ring fence provisions and in October 2011 the Gas and Electricity Markets Authority decided that we should proceed with formal licence modification proposals. This paper updates our position in that regard and sets out the changes we have made in light of consultation responses.

We currently expect to issue formal licence modification notices in September 2012 and, subject to consideration of any representations and objections, we envisage that licence modifications could be made effective from 1 April 2013.

1. Background to our updated proposals

Background

1.1. Ring fence conditions were introduced into network operator (NWO) licences in the mid 1990s in the wake of energy industry privatisations. They were designed to provide assurance that network operators always have the financial and operational resources necessary to fulfil their obligations under legislation and their licences. To date, they have proved to be an effective part of the regulatory framework.

1.2. The main objectives of the ring fence with respect to network licensees are:

- to prevent 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;
- to provide warning signals when symptoms of financial distress appear or potential threats are identified;
- to mitigate the severity and impact of financial distress factors should they arise and reduce any 'chain reaction' of adverse financial events; and
- in extremis, to facilitate price control reopener measures or the special administration process.

1.3. In 2009 we commenced a review of the ring fence conditions with a view to updating and enhancing the regime because:

- the financial and operating structures around network businesses and the associated risks have changed significantly since the 1990s; and
- the liquidity crisis of 2008 and ongoing economic concerns have highlighted additional issues which need to be addressed.

1.4. In our March 2010 Impact Assessment and Consultation (see associated document 'a') we referred to the possibilities of adopting either a much more, or much less, intrusive approach to achieving the ring fence objectives in future. We also considered the possibility of making no changes to the ring fence. However, we explained that our preferred approach was to improve the existing ring fence provisions through a focussed package of licence modifications.

1.5. Having considered the responses to the March 2010 publication we published a further consultation document in March 2011 (see associated document 'b') which contained details of revised modification proposals. This consultation, in common with the earlier publication, elicited a significant number of carefully considered responses from network licensees.

1.6. In October 2011, the Authority decided that we should develop a full set of proposed modifications for each type of licensee, incorporating additional changes in light of responses to the March 2011 consultation (see associated document 'c'). The Authority also decided that, subject to consultation, we should programme the publication of formal, statutory proposals with a view to licence modifications being implemented on 1 April 2013. It should, however, be noted that some of the proposals would provide for the effective date of new requirements to be deferred until 1 April 2014.

1.7. The new price controls for transmission and gas distribution licensees (respectively RIIO-T1 and RIIO-GD1) will commence on 1 April 2013. The RIIO approach to network price controls places emphasis on the linking of licensee revenues to incentives, innovation and the achievement of outputs, in the context of the Authority's duty to *have regard to the need to secure that licence holders are able to finance the activities which are the subject of obligations imposed by [relevant legislation]*. Clearly, the price control settlements for licensees are a key factor in the overall financial stability framework. However, we consider that our updated proposals complement, and are consistent with, the RIIO approach and the Authority's duty referred to above.

1.8. We addressed our earlier consultations to consumers, generators, shippers/suppliers and finance providers as well as network operators and their owners. However, all but one of the responses we received came from network operators or their owners. In updating our proposals, we have nonetheless had a strong regard to the interests of energy consumers, in keeping with our principal objective.

1.9. We expect that the proposed modifications should ensure that the ring fence regime remains fit for purpose for years to come and do not consider that they should be unduly burdensome for NWOs, their managers or owners.

Updated proposals

1.10. The updates we have made to our proposals are described in chapter 3 of this document together with comments on the responses we received to the March 2011 consultation. Our updated proposals are also summarised in bullet point format in Appendix 1, which shows separately the revisions made since the March 2011 consultation. Our latest proposals include a minor change to the Credit Rating condition (shown as unchanged in the March 2011 consultation) to include DBRS Ratings Ltd as an eligible rating agency.

1.11. Further information on the existing ring fence conditions and the background to our proposals can be found in chapter 3 of associated document 'b').

1.12. The details of proposed modifications are shown in the form of marked-up copies of existing licence conditions in appendices 4 to 8 in the supplementary appendices document (Ref 85a/2012). Appendix 9 contains an example form of Ultimate Controller Undertaking which we propose to specify for each type of licensee at the same time as making the formal modification proposals referred to in

paragraph 1.6. The specification of new forms will be carried out under existing licence provisions, but is pertinent to the proposed modification of the Ultimate Controller Undertaking condition (see chapter 3).

1.13. We have not sought to conform the wording used across different types of licence in our proposals except where, for practical drafting purposes, whole sections of text would be replaced. This is because updates to forms of words are best accomplished under separate, 'whole licence' reviews so that consistency within each licence is maintained. However, the proposed ring fence modifications should have equivalent effects across the different types of licence (subject to the limited exceptions set out in chapter 3).

1.14. We are aware that our proposals would necessitate minor consequential adjustments to Special Condition C1 in the Gas Transporter Licence held by National Grid Gas plc in respect of the national transmission system. We will address this point when making any formal licence modification proposals.

1.15. We are particularly grateful for the work carried out by industry reviewers to improve the wording and layout of possible modifications, much of which is reflected in the revised modification proposals in appendices 4 to 8.

Responding to this document

1.16. We will consider all responses to this document submitted by the deadline date of 31 August 2012. We have not set out any particular questions, but we would be interested to receive comments on:

- any new or previously unrepresented issues or areas of concern;
- the updates we have made to proposed modifications following the March 2011 consultation;
- the formal drafting presented in appendices 4 to 8;

1.17. This document builds on and updates the position set out in our earlier consultations (see associated documents 'a' and 'b'). We have not repeated all the material included in the preceding documents and it is recommended that the full sequence of documents be reviewed to obtain a complete understanding of the issues leading up to the current position.

2. Summary of responses to the questions in our March 2011 consultation

2.1. We set out a series of questions in our March 2011 consultation document. A summary of the responses to those questions is provided below. All of the non-confidential responses we received to the 2011 consultation can be accessed on the Ofgem website page specified for associated document 'b'.

2.2. Most responses were made on a corporate group basis covering more than one network licensee. More specific response points are addressed in chapter three under the headings relating to each of our updated proposals.

Chapter 1

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?*

Several respondents felt that the new measures being proposed did not address clear risks whilst others were supportive of the review but had concerns about particular proposals. One respondent made the point that the costs and benefits of the proposals should be carefully weighed. Some independent network operators were concerned that the proposals could impinge on their ability to stimulate competition in the distribution sector.

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

A number of respondents expressed the view that sufficient lead-in times should be allowed between the date of any licence modifications and the effective date of new requirements. Additionally it was felt that licence modifications should be timed to coincide with the start of a new regulatory year and/or price control period. Most felt that a preparation period of up to 12 months would be necessary in relation to proposed requirements for sufficiently independent directors and intervention plans (under the Availability of Resources condition).

Chapter 3

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

The groups that considered that our proposals were not addressing clear risks also felt that our proposed measures were disproportionate, especially the proposed requirement for sufficiently independent directors. Others, whilst having concerns on some points, felt that our 2011 proposals had improved upon the earlier package.

One respondent suggested that additional guidance should be provided on practical aspects of compliance with any modified conditions.

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

Most groups considered that we had addressed at least some of the policy and drafting concerns raised in response to our earlier consultation. One respondent felt that we had not sufficiently considered the importance of other regulatory controls or of the new RIIO approach to network price controls in relation to financial stability.

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?*

Several of the network operators who responded felt that the existing ring fence regime was fit for purpose and one felt that we had not adequately considered the possibility of 'doing nothing'. However, a number of respondents were of the opinion that the review was sensible at the present time.

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

Most respondents agreed with the principal of applying exceptions to requirements where appropriate for specific types of licensee. One group recognised the need to cater for the particular financing arrangements applicable to offshore transmission network operators but, with this exception, felt that requirements should be applied across all types of licensee.

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

We encouraged addressees to submit comments on the draft modifications appended to the March 2011 consultation document without prejudice to their position on policy aspects. We received a significant number of helpful responses including detailed contributions from the ENA DNO¹ licence drafting group. These responses have been reflected in the updated draft licence modifications appended to this document.

¹ ENA: Energy Networks association & DNO: (Electricity) Distribution Network Operator

Chapter 4

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?*

Responses to this question divided into two camps. Three network operator groups were firmly of the view that the proposed requirement for sufficiently independent directors was disproportionate. Several other groups considered that the proposed requirement was positive, although suggestions were made on some aspects of drafting and on the eligibility criteria for candidates.

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?*

Respondents to this question acknowledged that the move away from our initial proposal for a majority of independent directors dealt with a particular issue of concern. However, the three respondents who remain opposed to a requirement for sufficiently independent directors asserted that any requirement relating to board composition would impinge on business control.

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

Responses to this question divided along similar lines to question 1. Three groups felt that, in respect of corporate governance, emphasis should be placed on the role of non-executive directors at group level. Two other groups expressed the view that group level governance would not be a substitute for sufficiently independent directors on licensee boards. One respondent reiterated its counter-proposal for the audit of pre-dividend resource certificates based on a view that, if there is a risk to be addressed, it probably relates to the circumstances in which a licensee could pay out a dividend.

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

As mentioned under Question 5 on page 9, we received a large number of helpful drafting suggestions.

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?*

Nearly all respondents considered that a meaningful preparation period for any requirement should be allowed, with views ranging from a period of six to twelve months.

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?*

The independent distributors who responded considered that any proposed requirement would be disproportionate in relation to the size of their businesses. Of the three larger network groups that responded on this point, two did not consider that exemptions were necessarily valid whilst one acknowledged the rationale for excluding very small businesses from a requirement.

3. Updates to proposed ring fence condition modifications

3.1. This chapter summarises the main representations made in relation to each licence condition in responses to our 2011 consultation publication. It also sets out our reasons for updating our proposals in light of the consultation responses or for maintaining our original view.

3.2. All of the non-confidential responses we received to the 2011 consultation can be accessed on the Ofgem website page specified for associated document 'b'.

Disposal of Assets condition

3.3. The proposed modification to this condition would extend the existing restrictions on the licensee granting security rights over its network assets so that they would also apply to receivables on the licensee's balance sheet. In the 2011 consultation document we noted that it would be open to the Authority to consent to the granting of security rights over receivables in response to a notice from the licensee.

3.4. The proposed modification would not apply to offshore transmission network operators (OFTOs).

3.5. In summary, the following points were made by respondents to the 2011 consultation:

- (1) The restriction may be unduly prescriptive and should not in any case be retrospective.
- (2) It should be possible to 'rollover' a charge when particular borrowing facilities are renewed.
- (3) If the possibility of a charge holder obtaining the right to appoint an administrator is a concern, why not just prohibit charges conferring this right?
- (4) The proposed restriction overlaps with requirements under the Availability of Resources condition.
- (5) There are many measures which might conceivably improve the circumstances of a special administration, but that is not an argument in favour of this restriction.

3.6. We recognise that this measure would impose an additional regulatory restriction on network businesses, but consider that it is justified for the reasons set out in chapter 3 of our March 2011 consultation document. In particular, it will allow us to gauge the risk associated with new security rights, especially those of an

unusual nature. However, our updated drafting addresses a number of the concerns which have been raised. The updated drafting:

- makes clear that the restriction would only apply to charges granted after the date of any licence modification;
- specifies that if the licensee gives notice of an intended charge, the Authority must not unreasonably withhold its consent; and
- provides for charges to be granted without the need to give notice where the borrowing to be secured represents the novation or rollover of existing indebtedness, and the proceeds of the new facility are used to clear the existing indebtedness.

3.7. The change referred to in the third bullet point above addresses the specific point raised at paragraph 3.5(2). The revised drafting also introduces a distinction (an explicit reasonableness test) between consideration of consent for a charge over receivables and consideration of consent for a charge over network assets (where the circumstances in which consent would be given are very limited).

3.8. We acknowledge that there is some overlap of protection across the ring fence conditions, but as we have explained in our earlier consultations, we consider the ring fence conditions to be synergic in nature, with complementary provisions adding to the overall effectiveness of the regime. We have received no compelling evidence that changed our views on this.

Availability of Resources condition

3.9. The proposed modification in relation to this condition would extend the scope of the annual availability of resources certificate completed by each licensee so that in addition to covering financial resources, certification would also cover the availability of operational resources and compliance with a range of key licence conditions, including several of the ring fence conditions. In addition, the proposed modification would require the licensee to maintain an 'intervention plan' providing key financial and operational information relating to the licensee's business.

3.10. In summary, the following points were made by respondents to the March 2011 consultation:

- (1) It is unreasonable to expect licensees to form a view on the stability of suppliers and other third parties.
- (2) The requirement for an intervention plan will have no preventative value with respect to financial distress.

3.11. Although we have not made any substantive changes to the modifications we are proposing from those set out in our 2011 consultation, we have significantly improved the lay-out of requirements based on feedback from respondents. The proposed update in relation to OFTOs includes some additional wording to cater for

the timing of certificate submissions in the period shortly after the granting of a licence.

3.12. In relation to the response point set out at paragraph 3.10 (1), we believe (as indicated on pages 17 to 18 of our March 2011 consultation document) that 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 following 12 months. The requirement would not imply that NWO managers should be able to obtain information on the financial position of unrelated third parties beyond that obtainable through normal contractual diligence.

3.13. In relation to the response point set out at paragraph 3.10(2), we consider that whilst an intervention plan would not have preventative value per se, its availability would be important in achieving the objectives set out in paragraph 1.2 in a range of possible scenarios, and not just in an insolvency situation.

3.14. We are not proposing any new requirement for information on Availability of Resources certification to be published.

Intervention Plan

3.15. We are aware that the list of 11 types of information set out in the definition of Intervention Plan has led to concerns that the compilation and maintenance of the plan will be burdensome and expensive. However, the requirement is essentially to draw together the type of information that could reasonably be expected to be available to the management of a business in any case and to ensure that it is accessible by those responsible for managing the licensee's network business, notwithstanding any intra-group organisational arrangements. We consider that there could be more uncertainty on requirements if the draft condition did not provide a list of information to be covered, or only provided a general description.

3.16. The drafting of the proposed condition makes clear that the plan can cross-refer to existing documents or records (including electronic records) provided that those separate records meet the accessibility criteria. The particular contents and format of the Intervention Plan are for a matter for NWO management and could be expected to vary with respect to the size and complexity of businesses. The proposal does not include a requirement for the plan to be routinely submitted to Ofgem, although the plan is something that could be discussed during regulatory visits or reviews.

3.17. The proposed licence modification would not require the licensee to have its Intervention Plan in place until 1 April 2014 and this will provide us with an opportunity to respond to any 'frequently asked questions' on content and format which might arise.

Ultimate Controller Undertaking condition

3.18. The proposed modification in relation to this condition would require the licensee to provide us with a list of its ultimate controllers² each year and confirm that its ultimate controllers had been reappraised, on an annual basis, of the terms of undertakings given to the licensee.

3.19. One respondent to our 2011 consultation did feel that a requirement to re-visit undertakings every year could be disproportionate, but we consider that the proposed requirement would routinely amount to the drafting of just two letters each year, but would nonetheless have significant value.

3.20. We also intend to take the opportunity of this process to specify (under existing licence provisions) updated forms of ultimate controller undertaking which should be used by licensees when any new requirement for an undertaking arises. The updated forms will make fully clear that the undertaking will cover any modifications to the licence which occur after the undertaking is given. The annual reappraisal letter sent by the licensee to its ultimate controller(s) will provide an opportunity to bring any recent licence modifications to the ultimate controller's attention.

3.21. The proposed modification for OFTOs additionally removes a redundant undertaking requirement relating to ownership and operation of the network.

Credit Rating condition

3.22. We are proposing a relatively minor modification (not referred to in our 2011 consultation) to add DBRS Ratings Ltd and its affiliates to the list of specified credit rating agencies referred to in the condition. This should allow licensees some additional choice in complying with the credit rating requirements.

3.23. The proposed modification for OFTOs adds an option for the licensee to obtain appropriate investment grade instrument credit ratings reflecting the project financing associated with their businesses.

Restriction of Indebtedness condition

3.24. The proposed modification in relation to this condition would add two additional triggers to the mechanism which can tighten the restriction on payments and transfers that the licensee can make to affiliates or related undertakings (the 'cash lock-up').

² Most licensees will have one ultimate controller, but the definition of the term means that it is possible for more than one person to be considered an ultimate controller

3.25. In summary, the following points were made by respondents to the 2011 consultation:

- (1) A cash lock-up should not be triggered by a technical covenant breach resulting from, for example, a change to an accounting standard.
- (2) A cash lock-up should not be triggered by an adverse resource certification relating to non-financial factors.

3.26. After considering responses to the March 2011 consultation, we have made two changes to our proposals for this condition.

3.27. Firstly, a lock-up would not be triggered by a certificate referring to non-compliance with certain licence conditions (referred to in paragraph 3.9 above). This recognises that significant financial or operational adversity should be caught by the other two certificate types and that it would be inappropriate for there to be a cash lock-up in relation to a compliance issue which might not impinge materially or at all on the licensee's financial situation.

3.28. Secondly, a lock-up would only be triggered by an adverse certificate (or interim notification) relating to operational resources, where the adverse circumstances concerned related to an affiliate or related undertaking of the licensee. This update acknowledges that, whilst adverse operational circumstances affecting an affiliate could introduce a financial risk to the licensee, operational difficulties affecting an unrelated third party would be considerably less likely to do so.

3.29. Our updated drafting also aims to make it clear when a lock-up circumstance would cease, and to bring the format of the condition in OFTO licences into line with that in other licence types.

Board Composition condition

3.30. Our detailed reasons for proposing a requirement for sufficiently independent directors (SIDs) are set out in chapter 4 of our March 2011 consultation publication (see associated document 'b').

3.31. The proposed modification would not apply to independent distributors or to OFTOs.

3.32. The following is a summary of points made by respondents to the 2011 consultation:

- (1) The proposal for SIDs unjustifiably interferes with the management and control of network businesses and might affect efficient decision making.
- (2) The proposal for SIDs does not address the risks highlighted by the global liquidity crisis – there is nothing to suggest they would enhance the

performance of the licensee board especially if they have the same duties as other directors of the licensee.

- (3) The proposal could be at odds with the duties imposed on directors by company law.
- (4) Insufficient weight has been given to the duties imposed on all directors by companies legislation and the deterrent effect of sanctions which could be applied.
- (5) Group level non-executive directors already have governance responsibilities with respect to subsidiaries.
- (6) The value of the ultimate controller undertaking has been under-stated.
- (7) Licensees who issue debt are subject to high levels of external scrutiny - a requirement for SIDs might upset investors.
- (8) Ofgem collects large amounts of regulatory information and should be well placed to spot financial problems at an early stage.
- (9) The eligibility criteria would exclude too many valid candidates especially existing group non-executive directors.

3.33. Whilst we are grateful for the responses to our consultation, we believe that we have addressed the arguments raised at points (1) to (8) above in our March 2011 consultation document. The Authority considers that the proposed requirement needs to be taken forward to ensure that the objectives for the ring fence (see paragraph 1.2 in chapter 1) continue to be met in light of the factors set out in paragraph 1.3 of chapter 1 of this document. However, we will continue to have regard to all the views expressed as we proceed to statutory licence modification proposals.

3.34. We have made some significant changes to the drafting of the proposed condition to reflect suggestions made by respondents and we have expanded the eligibility criteria to include candidates who are, or have recently been, non-executive directors of 'qualifying group companies'. In basic terms, a qualifying group is one which contains only NWO licensees and companies which serve only as holding companies of such licensee-only groups. In expanding the eligibility criteria in this way we have been cognisant of the following matters:

- It is important not to dilute the restrictions in the draft condition such that appointees might no longer be sufficiently independent with respect to the purposes of the proposed requirement.
- There may be high quality candidates who do not meet all of the specified criteria who could nonetheless be sufficiently independent. This is reflected in the facility for the Authority to consent to the appointment of such candidates. Whilst we would wish to minimise the need for consent applications, it would be impossible to cater in the drafting for every circumstance that might arise without weakening the intent of the proposed condition.
- The Authority's consideration of whether to consent to the appointment of a candidate who did not meet the specified criteria would be based only upon a

review of their characteristics of independence. It would not amount to an approval or rejection of the candidate in any other sense.

3.35. The opening paragraph of our updated drafting says:

"Except and to the extent that the Authority consents otherwise, the licensee must [] ensure that at all times after 1 April 2014 it has at least two directors who meet the criteria set out....."*

3.36. We had considered a suggestion to include the words "take all appropriate steps within its power to" at the point marked [*] above. However, on further consideration we are minded not to include this wording. Whilst most companies have articles that allow the board to appoint new directors, this is not universal and the primary responsibility for appointing directors lies with the company's shareholders. If we included the wording above, a situation could arise where only the shareholders had the power to appoint sufficiently independent directors but demurred. In that case, there might be no course of enforcement open to the Authority.

3.37. The terms of appointment for any sufficiently independent director would be a matter for the licensee and its owners, although the costs of complying with any requirement would fall within the broad efficiency test applied to the costs of price controlled NWOs. In that context we consider it appropriate to refer to the stipulation referring to the remuneration of directors in the UK Corporate Governance Code which says that *"Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose..."*.

4. Impacts/costs/benefits and next steps

Impacts costs and benefits

4.1. We consider that the views we set out on impacts, costs and benefits in chapter 5 of our 2011 consultation (see associated document 'b') remain valid.

4.2. We do not expect our proposals to have an immediate or direct impact on energy consumers, but over time consumers should benefit significantly from enhancements to the financial stability and governance framework for network operators (NWOs). We believe our updated proposals are proportionate and reflect the concerns expressed by respondents to earlier consultations where possible. The proposed licence modifications should make the ring fence provisions fit for purpose for the foreseeable future.

4.3. We acknowledge that our proposed requirement for sufficiently independent directors has proved contentious with some NWOs and we have made significant changes to our early proposals in response to feedback. We consider, however, that our revised proposals in this regard are necessary to ensure that the ring fence provisions continue to meet the objectives described in chapter 1.

4.4. We do not consider that our proposals will have any direct impact on sustainable development or health and safety aspects of network business operation.

Treatment of costs

4.5. If the proposed licence modifications come into effect from 1 April 2013, forecast incremental costs of compliance will not have been included in base revenue allowances for:

- electricity distribution licensees under the DPCR5 price control which commenced on 1 April 2010; or
- transmission/gas distribution licensees under the RIIO-T1/GD1 price controls which are due to commence on 1 April 2013.

4.6. Although the costs involved should be relatively immaterial in comparison to other components of base revenue allowances, we consider that NWOs should be allowed to 'log-up' the efficient costs of complying with any new licence requirements for reimbursement in allowances set for the following price control period. In that case relevant costs would be reported during the existing price control period, outside the scope of Totex incentive mechanisms.

4.7. Independent distributors and Offshore transmission operators are subject to different price control arrangements meaning that efficient costs do not feed into

allowed revenues through cost assessment reviews. However, neither of these licensee types would be subject to incremental costs associated with the proposed requirement for sufficiently independent directors (see paragraph 3.31).

Next steps

4.8. We will carefully consider any responses to this document received by the deadline date of 31 August 2012.

4.9. We currently expect to be in a position to issue statutory notices relating to proposed licence modifications in September 2012. Those notices will specify a period of at least 28 days from the date of publication during which representations or objections can be made.

4.10. The Authority will reach its decisions on licence modifications after considering any such representations or objections. Licence modification could not take effect less than 56 days from the date of publication of the Authority's decision. This period allows for the process of appeals to the Competition Commission.

4.11. Full details of the legal requirements relating to licence modifications are set out in section 23 of the Gas Act 1986 and section 11A of the Electricity Act 1989. Care should be taken to refer to up-to-date copies of the Acts which include amendments under the Electricity and Gas (Internal Markets) Regulations 2011.

4.12. Subject to the procedures and requirements described above, we currently expect that the ring fence conditions in network licences could be modified with effect from 1 April 2013.

Appendices

Appendices 1 to 3 to this document are included below.

Appendices 4 to 9 are included in a separate appendices document (Ref 85a/2012)

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Appendix 1 - Summary of changes to the 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 full existing text in each type of licence and to the draft modifications shown in Appendices 4 to 8 for full details.

1.2. Red text indicates the changes proposed in our consultation document (Ref 42/11) dated 25 March 2011 (see Associated Document 'b') and blue text shows the subsequent updates to modifications we intend to propose.

Disposal of Relevant Assets [not proposed for OFTOs³]

Unless Authority consents (possibly with conditions)⁴

- No disposal of/granting of security over/relinquishment of control over network assets, control centres and land rights
[several categories of exempt disposals and resource provider can take operational control but 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) –
 - Consent not to be unreasonably refused
 - Consent not required where new borrowing represents a novation or rollover of existing debt, in respect of which security over receivables was granted, and proceeds of new borrowings are used to clear the maturing debt concerned

³ Offshore transmission network operators

⁴ 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

- 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
 - 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 financial and operational 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 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 reminded 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 endeavour to maintain investment grade credit rating (long term/senior debt)
- Addition of DBRS Ratings Ltd and its affiliates to the list of specified credit rating agencies
[Reference to instrument credit ratings – OFTOs only]
- 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

.....ctd

- 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);
- licensee makes adverse annual availability of resources certificate [does not apply to licence compliance certification];
- licensee makes any report of adversely changed adequacy of resources status [only applies to adverse operational resources certificate if the point of concern relates to operational resources provided by a related party]; or
- licensee breaches any banking or other financing covenants (unless pre-cleared by Authority):

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
- 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
- No new/renewed cross default obligations

Board composition [not proposed for OFTOs, IGTs⁵ or IDNOs⁶]

- At least two 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
 - Independent non-exec directors of 'qualifying group' companies eligible

⁵ Independent gas transporters

⁶ Independent (electricity) distribution network operators

Appendix 2 - Glossary

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.

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

Reopener

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

Totex

Total expenditure – an NWO's capital (capex), replacement (repex) and operational (opex) expenditure on its network business (with certain excepted items).

Appendix 3 - 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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