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Tel: 01738 456107
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Dear Paul,

Changes to the ring fence conditions in network operator licences

SSE and Scotia Gas Networks (SGN) welcome the opportunity to comment on the above position paper.

We wish to reiterate our continuing opposition to the proposal to impose a licence condition requiring network operators (NWOs) to have at least two sufficiently independent directors (SIDs) on their Boards. We initially expressed our concern in April 2010 that this proposal represented a fundamental and unnecessary shift in the operation and governance of network businesses, and effectively removed the efficient control that a network company has over the operation of its business. In July 2011 we re-iterated this concern, expanding on why we believe the proposal is a disproportionate response to the perceived risks set out by Ofgem, particularly as there are legal obligations under the Companies Act 2006 already in place to address such risks. Furthermore, Teachers' Pension Plan and Borealis Infrastructure, both shareholders of SGN, have previously written expressing significant concern with the proposals. This response should be read in conjunction with our previous correspondence.

Our fundamental issue remains that we view this obligation as potentially disruptive to the efficient governance of NWOs, and we do not believe that Ofgem has demonstrated that the likely benefits of this proposal outweigh the costs. Again we would urge Ofgem to undertake a quantified Regulatory Impact Assessment. Such an assessment would also have the purpose of setting out the benefits of this proposal, which otherwise remain vague and, as we describe below, highly subjective.

The primary benefit of this proposal cited by Ofgem is that it would reduce the risk of NWOs getting into financial distress during periods of economic downturn. However since March 2010, when Ofgem first considered reviewing the ring fence conditions and suggested the need for SIDs, the 2008 economic crisis has worsened; but no NWO has been in financial distress. It is clear therefore that the current ring fence conditions have proven more than adequate during the worst economic crisis since the great depression. We can see no additional value that SIDs could have provided during this period; or indeed, in the future.

More specifically, Ofgem has outlined two broad benefits it believes SIDs bring over effective group governance:

- Assertion of the identity of an NWO as a protected company; and
- An 'unconflicted' voice of reason with respect to the interests of the licensed NWO business at times of operational or financial stress

We do not agree with these broad benefits. Firstly, there is no evidence that board members of a subsidiary NWO are unclear of its status as a protected company. As is regularly asserted by Ofgem, the regulatory framework for energy in GB is transparent and robust, with sharp sanctions for non-compliance. Secondly, we are firmly of the view that the Companies Act ensures all company directors exercise independent judgement and reasonable care, skill and diligence i.e. they will be 'unconflicted'. This is the premise on which the UK corporate structure is based and we are not aware of any evidence that this has failed in the energy sector.

Issues not previously addressed

We appreciate that Ofgem are seeking comments on any new or previously unrepresented issues or areas of concern. We will pick up on these shortly. However, we do feel there are a number of areas that we have raised before that have not been fully addressed. These are:

- Existing directors have responsibilities under the Companies Act. Indeed, SIDs will have the same responsibilities including the requirement to act in the best interest of the company for the benefit of its members as a whole (i.e. its shareholders). It is not clear to us what additional service Ofgem expects mandated SIDs to provide – unless Ofgem believes that current NWO board directors are acting outwith their statutory duties;
- The impact on the boards of NWOs with multiple owners will be significant. Mandated board structures will impact the dynamics of the board; reduce diversity and the potential for innovative solutions that others will then follow. In our opinion, mandated board structures are at odds with the principles of RIIO; and
- The proposed new 'compliance' licence condition is likely to strengthen NWOs' approaches to licence compliance, including the role of the NWO board. Along with the undertaking from the ultimate controller (including the proposal for an annual reminder) it will complement the existing ring fence provisions to ensure the needs of the business are not compromised by the needs of other parts of a group business.

Alternative solutions have previously been suggested and, again, not fully addressed by Ofgem. For example, if Ofgem's concern is that NWO board directors might approve an inappropriately large financial dividend (in contravention of their statutory duties and existing licence obligations) then an alternative (and demonstrably better) solution might be to require an independent audit report on pre-dividend certificates.

This would impose little regulatory burden on either the licensee or Ofgem and would dovetail well with the proposed new 'compliance' licence condition. It is not clear how SIDs could ensure inappropriate loans or asset transfers better than the ring fence licence conditions covering availability of resources, disposal of assets and indebtedness.

New issues

Notwithstanding the points above, there has been significant change in the regulatory regime since Ofgem's 2009 'war games' that initiated the review of the ring fence conditions. These include the new RIIO framework with its move to outputs based regulation, increased transparency and the proposed new compliance condition. All these changes positively strengthen the current ring fence framework.

In addition, since 2009, there are now many more licensees with multiple owners; along with revised enforcement guidelines and new consumer redress powers. Again these changes positively strengthen the current ring fence framework.

None of these changes have been taken into account as the new ring fence conditions, in particular the requirement for SIDs, have been developed. It is particularly disappointing that this consultation does not acknowledge these changes but instead sticks dogmatically to a view established three years ago in a different regulatory landscape.

We are still, therefore, of the opinion that the proposal to impose a licence condition requiring NWOs to have at least two SIDs on their Boards is unnecessary and massively disproportionate to Ofgem's perceived risks. We continue to believe that Ofgem has not provided sufficient justification, adequately supported by a full Regulatory Impact Assessment, for such a material change.

In addition to these ongoing concerns, we have some comments on the draft suite of ring fence licence conditions and have attached these as an appendix to this letter.

This letter should be read in conjunction with our previous responses and those of our shareholders. For ease of reference, these are all attached. If you would like to discuss our response further, please do not hesitate to contact me.

Yours sincerely,

Aileen McLeod
Head of Regulation, Networks

Appendix: response to draft ring fence licence condition modification notices

Availability of resources

With regard to the requirement to maintain an Intervention Plan, we believe that once the Plan is prepared then it should be reviewed and maintained on an annual basis. It is simply not practical to maintain such a plan '… at all times thereafter …' given that documents that are proposed to make up the plan are fluid (e.g. the personnel of the licensee could change daily). We suggest that the drafting should be 'At least once a year', which is similar to the compliance statements and charging methodologies licence conditions.

With regard to the documents that are proposed to make up the plan, with regard to (b) ***non-financial assets, rights and resources***, a clear definition of what constitutes rights is required.

Undertakings from ultimate controller

We do not believe it necessary to require confirmation that the licensee has written annually to each of the Ultimate Controllers a letter re-apprising the Ultimate Controller of the terms of the undertaking it has given.

Once made the undertakings are legally enforceable. Indeed, the licensee is already required to inform the Authority immediately if its directors become aware that any such undertaking has ceased to be legally enforceable or that its terms have been breached. The addition of the proposed annual 'reminder' simply adds bureaucracy to the process and it not, in our view, proportionate or compatible with principles of Better Regulation.

Requirement for sufficiently independent directors

Notwithstanding our continuing concerns with the proposal to require a NWO to ensure it has two SIDs, if such a licence condition is imposed on NWOs we wish to make the following observations regarding the draft licence condition:

- Clause 2 needs to begin '***A Sufficiently Independent Director must, in the reasonable opinion of the licensee*** …'
- We suggest that Clause 2b should read as follows: '… have the skills, knowledge, experience and personal qualities necessary to perform effectively as a non-executive director of the licensee **in accordance with the duties of a director as set out in sections 170 to 177 of the Companies Act 2006**.'
- Clauses 3 & 4 appear to be very restrictive. It is unclear how, in practice, clause 4 relaxes the requirements of clause 3 to all but a very few licensees. As drafted, it does not allow us to appoint SSE plc non-executive directors as SIDs on our network boards. Thus the definition of a qualifying group company needs to be revised to include companies where the holding company has wider interests than just licensed networks
- Clause 6 (a) will require clarity on how '… a small number of shares …' is to be interpreted e.g. what is meant by 'small'? We suggest that 5%of shares in issue is appropriate
- Clause 8 simply appears to reiterate the requirements clauses 2, 3 & 5 and is therefore superfluous.
- Clause 9: it is unusual to appoint non executive directors for longer than 3 years (with potential for re-appointment). We would therefore suggest that the appointment period is amended to 3 years (with potential for re-appointment) rather than 8
- Clause 11 is extremely onerous. It needs to be amended to ensure that, in event of a vacancy due to resignation / removal, whilst it is the licensee's responsibility to recruit an appropriate candidate, a gap in appointment to allow due process to take place does not constitute a breach of licence obligation.