

Updated Proposals for Changes to Ring Fence Conditions and their Impacts

Consultation

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Overview:

This document describes the changes we expect to make to our ring fence modification proposals as a result of feedback on the position paper consultation we published in July 2012 and the impact of those changes. It also addresses points of concern and arguments raised in responses, including those regarding our proposed requirement for sufficiently independent directors.

It sets out our view that a newly defined term, 'associate' of the licensee, should replace existing references to 'affiliates' and 'related undertakings' in the proposed new condition relating to sufficiently independent directors and in the indebtedness and availability of resources conditions. The new term, associate, would expand the scope of the exclusions and restrictions concerned to some extent.

We would be pleased to receive comments and feedback on any of the matters covered in this document and, in particular, on the possible benefits, drawbacks and impacts of applying the new term, associate, referred to above.

Following consideration of any responses to this paper, we now expect to issue our formal licence modification proposals in December 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.

We published a position paper consultation in July 2012 which set out our proposed changes to the ring fence conditions in network operator licences. At that stage we expected to be in a position to issue statutory notices of proposed licence modifications in late September 2012. However, following the latest consultation, we consider that a number of changes should be made to our proposals. Although most of the changes are relatively minor, they include the use of a newly defined term, 'associate' in the proposed new condition relating to sufficiently independent directors and in the indebtedness and availability of resources conditions. This change in particular might have a substantive affect on licensees or other stakeholders and we therefore wish to provide an opportunity for views and comments to be expressed before any statutory consultation on our proposed modifications. We now expect to issue our formal proposals in December 2012.

Associated documents

- a) [Ofgem website page with Impact Assessment /Consultation - Review of the 'Ring Fence' Conditions in Network Operator Licences \(Ref 30/10\) and published stakeholder responses](http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=268&refer=Networks/Policy)

<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)

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

- c) [Regulatory Ringfence Update letter dated 13 March 2012](http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=367&refer=Networks/Policy)

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

- d) [Position Paper – Changes to the Ring Fence Conditions in Network Operator Licences \(Ref 85/12\) and published stakeholder responses](http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=392&refer=Networks/Policy)

<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=392&refer=Networks/Policy>

Contents

Executive Summary	4
1. Introduction and reasons for further consultation	5
Responses sought	6
2. Updates to our proposals following consultation	7
3. Feedback on proposed requirement for sufficiently independent directors	12
4. Reference to a new term: 'associate' of the licensee	18
Proposed use of a new term 'associate' in certain licence conditions	18
Feedback sought	21
5. Impacts/costs/benefits and next steps	22
Impacts costs and benefits	22
Next steps	22
Appendices	24
Appendix 1 – Drafting extracts illustrating updated proposals	25
Appendix 2 – Updated draft condition relating to sufficiently independent directors (electricity distribution version)	28
Appendix 3 - Glossary	31
Appendix 4 - Feedback Questionnaire	33

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 customers throughout Great Britain. The ring fence conditions in NWO licences help to ensure that relevant assets, cash flows and other financial resources are applied to meet the needs of the regulated businesses. They are also a key measure that helps to manage the risk that a network operator could be affected by financial distress. The existing ring fence conditions cover:

- restrictions on disposing of or granting security over network assets;
- a requirement to have all necessary resources available to run the network business;
- a requirement to obtain undertakings from ultimate controllers of network companies regarding licence compliance;
- restrictions on indebtedness;
- credit rating requirements; and
- restrictions on non-network business activity.

Since 2009 we have been carrying out a review of the ring fence conditions to ensure that they remain fit for purpose for years to come. We are proposing changes to five of the existing conditions and the addition of a further condition for most licensees containing a requirement for the licensee to have at least two sufficiently independent directors.

We have carried out three consultations in the development of our proposals and this document provides feedback to stakeholders on the changes we have made following the most recent of these. It also provides comments on concerns raised in relation to our proposal relating to sufficiently independent directors. In chapter 4 we set out a particular drafting change which we now consider necessary. This concerns the possible replacement of the terms 'affiliate' and 'related undertaking' in three of the ring fence conditions with a newly defined term of 'associate'. The change would have the effect of expanding the scope of relevant exclusions and restrictions.

Most of the changes that we are proposing in response to the July 2012 consultation are relatively minor and are not expected to significantly change the impact of modifications on licensees and other stakeholders. However, use of a new term, 'associate' of the licensee for some purposes could have a more significant impact and we are therefore seeking views and comments before making our formal proposals in a statutory consultation. Chapter 5 of the document discusses the impact of these changes. We have included illustrative drafting extracts at Appendices 1 and 2 to this document.

This document should be read in conjunction with our earlier consultations and the responses thereto – see the 'associated document' links on page 2. This consultation ends on 30 November 2012 and, following consideration of responses, we expect to publish our formal licence condition modification proposals in December 2012.

1. Introduction and reasons for further consultation

1.1. Since 2009 we have been carrying out a review of the ring fence conditions in energy network operator (NWO) licences to ensure that they continue to meet their objectives in light of changing business profiles and perceived risks.

1.2. This consultation describes the changes we are making to our proposals following consultation on the draft modifications that we published in July 2012. It contains:

- (1) information on various changes we are making in response to particular licensee suggestions;
- (2) comments on concerns raised by some respondents in relation to sufficiently independent directors; and
- (3) details of a further change we are proposing which would expand the scope of some exclusions and restrictions in three of the draft conditions.

1.3. We are grateful for all of the responses and review work carried out by respondents to date which has resulted in a number of meaningful changes to our drafting, which are explained in chapter 2.

Sufficiently independent directors (SIDs)

1.4. In chapter 3 we address concerns raised on our proposal for sufficiently independent directors in respect of:

- control and proportionality;
- interaction with group level governance;
- consistency with companies legislation; and
- concurrence with the RIIO approach and the ring fence objectives.

Use of new term - 'associate'

1.5. Chapter 4 sets out our proposal to replace the existing terms 'affiliate' and 'related undertaking' with a new term 'associate' (into which the existing terms are subsumed) for the purposes of the draft condition for sufficiently independent directors, as well as the restriction of indebtedness condition. The change would also impinge on requirements for an intervention plan under draft changes to the availability of resources condition.

1.6. We consider these changes are necessary to ensure:

- the sufficient independence of eligible SID candidates; and
- the effectiveness of restrictions on indebtedness and the cash lock up provisions in light of changing business structures and financing arrangements.

1.7. We believe that these changes, prompted by feedback on the drafting published in July 2012, are consistent with the objectives of the ring fence review which we have set out and the overall package of proposed modifications. However, we are cognisant that these changes might have impacts in respect of existing (indebtedness) or envisaged (SID) arrangements.

1.8. Finally, we discuss the impact of these changes in Chapter 5.

Responses sought

1.9. This document should be read in conjunction with our earlier consultations (see associated documents) and the responses thereto, as it does not repeat all of the arguments and information which have brought us to this stage.

1.10. Appendices 1 and 2 contain drafting extracts illustrating the changes we have made to our proposals. These should be read in conjunction with the detailed drafting information contained in Appendices 4 to 8 of our July 2012 consultation paper (associated document 'd').

1.11. We will consider all responses to this document submitted by the deadline date of 30 November 2012.

1.12. We would be particularly interested to receive comments on our proposal to adopt a new term, 'associate' for use in a new condition relating to sufficiently independent directors and in the existing restriction of indebtedness condition. Details of this proposal are given in chapter 4 of this document. Respondents are requested to provide comments on the costs, impacts and benefits which they believe could be involved with the changes.

2. Updates to our proposals following consultation

2.1. This chapter provides information on various changes we have made to our proposed licence drafting in light of responses to our July 2012 consultation. It does not address in detail the proposed use of a new term, 'associate' of the licensee, which is covered in chapter 4.

Disposal of assets condition

Changes to proposals

2.2. One respondent queried whether the application of a reasonableness test to the consideration of notices relating to security over receivables might imply that consent for the disposal of relevant/networks assets could be 'unreasonably withheld'.

2.3. The Authority's statutory duties and the requirements of administrative law would preclude the taking of an 'unreasonable' approach to the consideration of a notice. However, having considered the position, we can see that our previous drafting might have appeared to carry such a connotation. We have therefore decided to remove the paragraph containing the provision from our draft modification of the disposal of assets conditions – see illustrative drafting extract 1 in Appendix 1.

2.4. For the purposes of considering the impact of our proposals, it is still relevant to make clear that there will be a practical distinction between the consideration of notices relating to network asset disposals on the one hand and security over receivables on the other. There are very few circumstances where the Authority would be likely to consent to the granting of security over networks assets. This is because of the risk of disruption to continuity of supplies involved, which might even frustrate the objectives of a special administration process. The Authority would be more likely to consent to a charge over receivables in relation to a notice setting out the commercial risks and rationale.

Availability of resources condition

2.5. One respondent queried whether a licensee might be motivated to submit a 'type 2' certificate in relation to financial or operational resources (ie including a description of factors which may cast doubt) so as to avoid a 'cash lock up' if such factors came to light after issuing a 'type 1' certificate. However, the relevant drafting in the restriction of indebtedness condition says that in such a case the cash lock up falls away once the licensee has submitted a 'type 1' or 'type 2' certificate after an adverse circumstances report. Therefore, if the licensee submitted a 'type 1' certificate, then later notified the Authority that factors casting doubt had arisen, it could, if appropriate, immediately submit a 'type 2' certificate setting out the factors concerned. In those particular circumstances the cash lock up would not apply. This makes sense, because in such a case, the board of the licensee would still be

certifying a reasonable expectation that the licensee would have sufficient resourcing levels.

2.6. One respondent suggested that the term 'non-financial assets, rights, and resources' included in the proposed intervention plan requirements should be further defined. We consider, however, that the term, as drafted, can be effectively interpreted in the context of the requirement and so we have not changed this drafting.

Changes to proposals

2.7. We have made the following changes to our proposed modification of licence conditions relating to the availability of resources:

- We have added drafting to the section of the condition that covers certificates in relation to dividends such that the licensee need not submit a further certificate within three months of submitting its annual licence condition compliance certificate, provided that an addendum referring to the payment of a dividend etc is included in the annual certificate. This should save administrative effort on the part of the licensee - see illustrative drafting extract 2 in Appendix 1.
- We have added the words "With effect from 1 August 2013" to the start of the sections relating to proposed requirements for annual certificates covering operational resources and licence condition compliance. This is to clarify that the first set of new certificates would not be due until 31 July 2014 and should allow licensees sufficient time to put processes in place.
- We have removed the words "at all times" in relation to the maintenance of an intervention plan to reflect a concern that the licensee would otherwise have to pay constant attention to the documentation.
- We have added a paragraph 17 with the wording "Not Used" to Standard Special Condition A37 of the Gas Transporter Licence (only), to facilitate the insertion specified in Special Condition C1 (Amendments to Standard Special Conditions relating to LNG) of National Grid Gas plc's NTS Gas Transporter licence.

2.8. We have replaced references to 'affiliates and related undertakings', in the new intervention plan criteria, with references to a new term, 'associate', which is defined in the draft condition. This has the effect of including ultimate controllers, companies that have a participating interest in the licensee/intermediate group companies, and common control companies in the references (see chapter 4).

Undertaking from ultimate controllers

2.9. One respondent expressed the view that the proposed requirement to reappraise ultimate controllers annually of the terms of their undertakings was unnecessary. However, we consider that this is an important measure for the reasons set out in paragraphs 3.40 to 3.42 of our 2011 consultation document (see

associated document 'b'). In addition, the process will mean that the licensee can update its ultimate controller(s) on any licence modifications which have come into effect during the preceding 12 months that will be relevant to the terms of the undertaking.

Form of ultimate controller undertakings

2.10. We have made a minor change to the draft direction relating to forms of ultimate controller undertaking to make clear that the new forms will only need to be used when a new requirement to obtain an undertaking arises – ie it will not be necessary for licensees to replace existing undertakings so long as they remain valid - see illustrative drafting extract 3 in Appendix 1.

2.11. One respondent suggested that the form of undertaking should exclude information not available to the ultimate controller or that the ultimate controller was not allowed to disclose. In this respect we note that the draft form reflects the stipulations in the relevant 'provision of information to the Authority' licence condition referenced therein, which is not subject to modification under this review. This condition already specifies certain types of information which the licensee is not obliged to provide. Furthermore, the draft form of undertaking is a development of the form which Ofgem has to date provided to licensees on an ad hoc basis and which has proved satisfactory. The only substantive change is a clarification in clause 4 of the undertaking, that references to the licence include any subsequent licence modifications. Therefore we do not propose to make any further change to the draft undertaking in this respect.

Credit Rating of the licensee condition

2.12. We have made the following changes to our proposed modification of licence conditions relating to licensee credit ratings:

- We have conformed all generic credit rating references in the licences to 'issuer credit rating' and 'investment grade credit rating'. This is consistent with references to investment grade issuer credit ratings in the restriction of indebtedness conditions. It also serves to avoid ambiguity with proprietary rating names and other classes of rating such as 'senior unsecured debt ratings' which may be assessed on varying bases - see illustrative drafting extract 4 in Appendix 1.
- We have made some changes to the proposed drafting at paragraphs 5 and 6 in Standard Condition E10 of the Electricity Transmission licence (relating to OFTOs) to clarify the position of instrument credit ratings in relation to the cash lock up mechanism - see illustrative drafting extract 5 in Appendix 1.

Restriction of indebtedness condition

2.13. One respondent suggested that the term "formal covenant pertaining to [...] financial affairs" should be defined in relation to particular financial instruments.

Whilst there can be benefits in defining terms with reference to specific items, in this case we consider that the existing description is adequate and interpretable and avoids the risk of excluding important items from a defined list. We therefore do not propose to make a change in this respect.

Changes to proposals

2.14. We have made the following changes to our proposed modification of licence conditions relating to restrictions on indebtedness and transfers of funds:

- For the electricity distribution standard conditions only, we have slightly changed the wording at the start of paragraph 41.13 which prohibits cross default obligations to make clear that it is subject to the permissibility of compliant guarantee arrangements. The equivalent wording in other licence types is already sufficiently clear - see illustrative drafting extract 6 in Appendix 1.
- We have replaced references to 'affiliates and related undertakings' with references to a new term, 'associate', which is defined in the draft condition. This has the effect of including ultimate controllers, companies that have a participating interest in the licensee/intermediate group companies, and common control companies in the references (see chapter 4).

Sufficiently independent directors – proposed condition (not applicable to OFTOS, IGTs or IDNOs)

2.15. Some respondents expressed concerns that the restrictions on eligibility included in the drafting of the condition could exclude valid candidates. In particular, reference was made to directors within corporate groups, or sub-groups, who do not have exposure to wider (non-network business) board or management responsibilities. We acknowledge this view, but consider we have extended the 'as of right' eligibility criteria as far as possible without undermining the effectiveness of the proposed measure. However, we have deliberately included a consent clause in paragraph 3 of the draft condition so that particular cases can be considered on their merits, with respect to sufficiency of independence.

2.16. One respondent felt that the reference to "a small number" [of shares or associated rights] in paragraph 6 of the draft condition should be clarified, and should perhaps refer to a percentage shareholding. However, we consider that this provision, which is subsidiary to the stipulations in paragraph 5 of the draft condition, is bound to be subject to the particular circumstances of a case. Our view, therefore, is that it would not be helpful to specify a percentage or market value of shares. The intent of the drafting is that, in considering whether a candidate has or has had a material business relationship with the licensee or its associates, the appointers need not automatically exclude a candidate who has a small shareholding which they consider does not represent such a material business relationship.

2.17. A view was expressed that paragraph 8 of the draft condition is superfluous, because it reiterates the requirements in paragraphs 2, 3 and 5. However, we

believe that this drafting inserts a specific additional measure to support ongoing compliance with the independence requirements in the paragraphs referred to.

2.18. One respondent felt that the requirement in paragraph 11 of the draft condition, for the licensee to “take all appropriate steps within its power [to fill vacancies] as soon as is reasonably practicable” is unduly onerous, and that a gap in appointments to allow for due process should not constitute a breach of the condition. We consider, however, that the drafting makes clear that it would be acceptable for the licensee to have a gap in appointments, subject to taking the required steps in the meantime. However, as described in paragraph 2.19 below:

- we have added wording at the start of paragraph 1 of the condition to make clear that it is subject to paragraph 11; and
- we have replaced the wording “take all appropriate steps within its power” with “use its best endeavours”.

Changes to proposals

2.19. We have made the following changes to our proposed new licence condition relating to a requirement for sufficiently independent directors (see revised draft condition in appendix 2):

- We have added wording at the start of the first paragraph to clarify that the requirement for the licensee to have two sufficiently independent directors at all times is subject to the provisions relating to vacancies at paragraph 11.
- We have changed the wording in paragraph 7 to make clear that the requirement for the licensee to notify the Authority of the names of its sufficiently independent applies within 14 days of the later of the two dates referred to in paragraph 1 of the condition.
- We have added “in the reasonable opinion of the licensee” in relation to the skills, knowledge and personal qualities of appointees.
- We have replaced references to ‘affiliates and related undertakings’ with references to a new term, ‘associate’, which is defined in the draft condition. This has the effect of including ultimate controllers, companies that have a participating interest in the licensee/intermediate group companies, and common control companies in the references (see chapter 4).
- We have replaced the wording “take all appropriate steps within its power” (with respect to filling vacancies) in paragraph 11 with “use its best endeavours”. This is in line with the wording which will be used in licence drafting for the RIIO price controls.

2.20. Some respondents reiterated concerns they hold in relation to the proposed requirement for sufficiently independent directors and we address these in chapter 3 of this document.

3. Feedback on proposed requirement for sufficiently independent directors

3.1. We set out the reasons for our proposed requirement for sufficiently independent directors in chapter 4 and appendix 4 of our March 2011 consultation document (see associated document 'b') and explained the interim updates to our drafting in our July 2012 position paper consultation (see associated document 'd'). Some respondents to the July 2012 consultation reiterated concerns they have, in relation to the proposed requirement, and although we consider that we have addressed the key areas of concern in our previous publications, we have provided additional comments on the recently expressed concerns below. We have published the non-confidential responses we received on the Ofgem website.

Interference with management control of the network business

3.2. Some concerns were raised that the requirement to have sufficiently independent directors on the board of a licensee which is a subsidiary within a complex group could impact on the owners' management control of the network business. It was argued that in the event of a financial or operational distress scenario, executive directors would be better placed to deal with problems because of their knowledge and experience. We agree that executive directors and managers would play key roles in dealing with exigencies. However, the licensee's sufficiently independent directors would be in a position to provide opinions or raise questions pertinent to the particular interests of the licensee which, as we note below, could diverge from those of its owners in some circumstances.

3.3. We appreciate that a regulatory requirement in relation to board composition might appear counter intuitive when we have expressed a clear view that primary responsibility for the financial and operational well being of each network operator lies with its managers and owners. We also understand that it might be perceived as the thin end of an interventionary wedge. However, we believe that our proposal, as updated, is justified within a wider package of measures that is intended to:

- make the ring fence regime fit for purpose for years to come; and
- avoid an unduly interventionary response to the change in risk profiles since the ring fence conditions were first put in place.

3.4. We accept that there would be some impact on owners' rights - they would be obliged to appoint licensee board members who they might not otherwise appoint. However, we consider that the degree of interference and impact, in terms of effective management control of the network business by its owners, would be limited because:

- appointments would be made by the business owners with no requirement for regulatory approval provided that the criteria for sufficient independence were

- met (except for consent applications in respect of candidates not meeting the criteria);
- the sufficiently independent directors need not be in a majority meaning that management control can remain with the owners;
 - the non executive duties of the sufficiently independent directors would be a matter for the appointers – they would have no ‘regulatory duties’ required by Ofgem;
 - the interests of the licensee can be expected to be aligned with the interests of a wider corporate group of which it is a member in normal circumstances.

3.5. We do not regard this proposal as being a precursor of other particular regulatory measures.

Proportionality

3.6. A view was expressed that the proposed requirement is disproportionate because the risks to a network business from distress in a wider business group are small. It was pointed out that no network operators had experienced financial distress during the global liquidity crisis which started in 2008.

3.7. We have acknowledged that the likelihood of a network operator being affected by financial distress within a larger group is small. However, the impact of such an event could be very substantial, meaning that the overall risk to be addressed is significant. We have explained that the ring fence conditions form a synergic package intended to:

- prevent the onset of financial/operational distress at network business level;
- provide early warning if symptoms of distress nonetheless arise;
- mitigate the severity of any financial distress factors; and, in extremis,
- facilitate price control re-opening or special administration.

3.8. As part of that package, the requirement for sufficiently independent directors could be expected to add value and be effective even if no full blown financial distress event occurred. It would of course be difficult to show conclusively a counter-factual position in future if no distress event arises – ie to show that a distress event could have arisen if measures had not been put in place.

3.9. As described in paragraph 3.4, we consider that the impact on licensees and ownership stakeholders in terms of interference would be relatively minor. We also consider that the financial costs of appointing sufficiently independent directors would be relatively immaterial, and we have said that the efficient costs involved could be recovered by network operators under price control arrangements.

Clashes with group level corporate governance

3.10. One respondent made the point that, for network operators which are part of UK listed groups, group wide governance is organised at listed company level, in accordance with the UK Corporate Governance Code¹ which requires independent non-executive directors to be appointed to the 'plc' board. They considered that the 'overlapping' of duties at group and licensee level might even be detrimental to governance.

3.11. We remain clear that the benefits to networks businesses from best practice corporate governance at group level are substantial. We consider it unlikely that there would be conflicts between the obligations of group level independent non-executive directors and sufficiently independent directors on licensee boards because in normal circumstances, the interests of the licensee company should be aligned with the interests of any wider ownership group. Sufficiently independent directors will not have any particular regulatory duties, executive duties or other duties, except those given to them by their appointers. Neither would we require licensee boards to be controlled by the sufficiently independent directors. We touch on the limited circumstances in which a divergence of interests might arise in paragraphs 3.18 to 3.21 below. Because we consider that the benefits of having sufficiently independent directors would apply to licensees in UK listed groups as well as those in other corporate structures, we do not believe that an exemption from the proposed requirement for such licensees would be objectively justified.

3.12. We do not believe that the proposed requirement would curtail flexibility in ownership, organisational or management arrangements. Indeed, we see it as part of an updated and effective ring fence regime that will provide the assurance levels needed to underpin a flexible business environment.

Consistency with companies legislation

3.13. Two respondents raised issues regarding the proposed requirement in relation to provisions of the Companies Act 2006² (CA 2006) which, in summary, were that:

- (1) all company directors have the same legal duties (including in relation to insolvency) – therefore, a requirement for sufficiently independent directors would be superfluous;
- (2) all directors have a duty to avoid conflicts of interest (s175 CA 2006) – making the requirement for sufficiently independent directors superfluous;
- (3) all company directors have a duty “.....to promote the success of the company for the benefit of its members as a whole....” (s172 CA 2006) –

¹ <http://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx>

² <http://www.legislation.gov.uk/ukpga/2006/46/contents>

meaning that where a company has a single shareholder its directors are bound to act in the interests of that shareholder; and

- (4) the draft requirement that a sufficiently independent director should "...not.....hold a remit to represent the interests of any particular shareholder" would be inappropriate where a licensee has a single shareholder.

3.14. We agree that all company directors have the same legal duties which include a duty to exercise independent judgment (s173 CA 2006) and a duty to avoid conflicts of interest (s175 CA 2006). We do not explore the detailed interpretation of these duties here, or the voluminous case law associated with them, but we consider it valid to say that:

- the legislation does not prohibit every scenario where a conflict of interest could arise; and
- in undertaking his duties³ in relation to a particular company, a director is bound to be influenced to some extent by the duties he owes to other companies of which he is a director and by his wider business responsibilities.

3.15. A sufficiently independent director should be in a position to express views, with respect to the licensee company in particular, from a perspective that is less constrained by formal duties to consider the interests of other entities which might be affected by a 'bigger picture', extending outside the network group, involving commercial or operational opportunity or adversity.

3.16. Input from sufficiently independent directors, at licensee level or through any role on a 'qualifying group company'⁴ board, is likely to be valuable at times of crisis, but should be beneficial at other times as well.

3.17. One respondent commented that there are many examples of companies with non-executive directors on their boards nonetheless suffering financial distress. We have made clear, however, that we see the proposed requirement for sufficiently independent directors as contributing to an updated, synergic ring fence regime in the context of the objectives outlined at paragraph 3.7 above.

3.18. With respect to the third argument summarised at paragraph 3.13 above, we would reiterate the views set out in paragraphs 4.21 to 4.23 of our March 2011 consultation document (see associated document 'b'). A director's duty under s172 CA 2006 is to *".....promote the success of the company for the benefit of its members as a whole..."*. We consider that the words "promote the success of the company" are significant and the words *"for the benefit of its members as a whole"*

³ In this document we follow the convention used in licence condition drafting that words denoting the masculine shall include the feminine.

⁴ See the definition at paragraph 12 of the proposed draft condition in Appendix 2.

are there to reflect the obligation on directors not to act to benefit one group of members at the expense of another.

3.19. In most circumstances what makes for the success of the company and what the majority shareholder(s) consider to be in its/their best interests will be one and the same thing. However, a company is a separate legal person, with rights and obligations distinct and separate from those of the persons who formed it. We cannot rule out the possibility of circumstances arising where the success of the company and the best interests of the majority shareholders, as they perceive them, diverge. An energy network operator is a special type of company, with duties under particular Acts of Parliament and its licence.

3.20. We acknowledge that the directors of any company might have to deal with tensions between shareholders' views of their best interests and the best interests of the company. However, a sufficiently independent director of a licensee company would be in a position to weigh issues free from duties or responsibilities in respect of a wider commercial backdrop.

3.21. The views set out in paragraphs 3.18 to 3.20 are also relevant to the fourth representation noted in paragraph 3.13. Although the interests of a company and a sole shareholder could be expected to be fully aligned in most circumstances, as mentioned above there could be scenarios where tensions arose. In that context, we consider that it would be inappropriate for a sufficiently independent director to hold a remit to represent the interests of any *particular* shareholder, even a sole shareholder. We do not believe that this would be inconsistent with the requirement set out in s172 of CA 2006 and referred to above. We consider this stipulation to be necessary, because it is not uncommon for the directors of subsidiary companies to hold such a remit either on a formal or informal basis.

Alternative measures

3.22. One respondent felt that we had not adequately considered the alternatives to our proposed requirement for sufficiently independent directors. We believe, however, that we addressed the specific alternative suggestion that was made, in our March 2011 consultation document (associated document 'b'). Paragraphs 4.35 to 4.40 of that document referred to the possibility of making the licensee's pre-dividend adequacy of resources certificates subject to an independent audit opinion. However, we set our view that this would not be an acceptable alternative because:

- the possibility of an inappropriate dividend being paid is only one of the risks which could arise;
- it would not make a contribution to corporate governance at licensee level;
- it is an example of a more interventionary approach of additional regulatory checks and controls which we considered had significant drawbacks; and
- there could be practical difficulties in engaging auditors to express an opinion on the adequacy of a licensee's resources.

3.23. It was also suggested that the proposed requirement might be unnecessary because regulatory assurance going forward will be boosted by the focus on output levels and performance by licensees under the RIIO⁵ approach to network price controls and the prospect of a 'compliance' licence condition which has been aired by Ofgem. In our opinion, neither of these factors is directly relevant to the risks which we have identified in relation to our proposed requirement for independent directors. The RIIO price control approach is certainly central to the financeability of network businesses but does not, of itself, address the range of risks which are managed under the ring fence regime.

3.24. Any 'compliance condition' proposed in future would address systems to comply with licence requirements, primarily relating to data assurance. It would not, however, address the particular risks we have referred to in our review of the regulatory ring fence.

3.25. In summary, we consider that the proposed requirement for sufficiently independent directors is necessary and proportionate. We also consider that the benefits we have set out justify the measure and that the impact on licensees and other stakeholders will be limited and mitigated by the revisions we have made in response to feedback we have received.

⁵ See Glossary

4. Reference to a new term: 'associate' of the licensee

Question box

Question 1: Do you agree that the present references to 'affiliates' and 'related undertakings' represent a weakness in provisions of the restriction of indebtedness condition and the proposed condition relating to sufficiently independent directors?

Question 2: Do you consider that the proposed replacement of those references with a new defined term of 'associate' will address any such weakness?

Question 3: Do you agree that a new definition of 'associate' for the purpose of these conditions should refer to:

- ultimate controllers of the licensee;
- 'participating owners';
- 'common control companies'?

Question 4: Do you consider that the introduction of a new term of 'associate' for the purpose of these conditions would be consistent with the objectives we have set out for our review of the regulatory ring fence?

Question 5: What additional impact do you think the introduction of the term 'associate' in these conditions could have on your business or other stakeholders?

Proposed use of a new term 'associate' in certain licence conditions

4.1. Following publication of our July 2012 position paper consultation (see associated document 'd') it was brought to our attention that our use of the terms 'affiliate' and 'related undertaking' to describe parties related to the licensee, for the purposes of restricting appointee eligibility might not be effective.

4.2. The particular concern relates to the scope of the term "affiliate". The Electricity Distribution Licence⁶ contains the most recently drafted definition of affiliate, which is reproduced below, but the other licence types contain substantially similar definitions.

Affiliate *in relation to the licensee, means any Holding Company of the licensee, any Subsidiary of the licensee, or any Subsidiary of a Holding Company of the licensee.*

⁶ Standard Condition1 – Definitions for the standard conditions

4.3. The terms Holding Company and Subsidiary are themselves defined in the Electricity Distribution Licence as follows:

Holding Company *in relation to the licensee, means a holding company within the meaning of section 1159 of the Companies Act 2006.*

Subsidiary *means a subsidiary within the meaning of section 1159 of the Companies Act 2006.*

4.4. The effect of the definition of "affiliate" is, in summary, to include undertakings above the licensee in a corporate group, but only as far up as there is a 50% (or controlling rights) line of relationships. Changing organisational and ownership profiles mean that it is more likely that, going forward, ownership groups containing licensees will include entities which fall outside the definition of affiliate, but which are nonetheless pivotal in financial or operational terms.

4.5. Having reviewed the position, we are of the opinion that the existing references to affiliates and related undertakings in our draft requirements relating to sufficiently independent directors and intervention plans, and in the existing restriction of indebtedness condition, are insufficient to ensure that the relevant objectives are met. Consequently, we consider that references to affiliates and related undertakings should be replaced by reference to a new term 'associate' of the licensee which would be defined as follows:

Associate *means:*

- (a) *an Affiliate or Related Undertaking of the licensee;*
- (b) *an Ultimate Controller of the licensee;*
- (c) *a Participating Owner of the licensee; or*
- (d) *a Common Control company.*

where the following definitions would apply:

Common Control Company *means any company, any of whose Ultimate Controllers (applying the definition set out in standard condition 1 (Definitions for the standard conditions) but substituting that company for the licensee) is also an Ultimate Controller of the licensee.*

Participating Owner - *For the purposes of the definition of Associate above, a person is subject to a Participating Interest by another person (a Participating Owner) if:*

- (a) *that other person holds a Participating Interest in the person;*
or
- (b) *the person is subject to a Participating Interest by a person who is himself subject to a Participating Interest by that other person.*

Participating Interest has the meaning given in section 421A of the *Financial Services and Markets Act 2000*⁷.

4.6. The effect of using the new term would, in summary, be to extend the range of parties covered in references to include:

- ultimate controllers of the licensee;
- companies holding shares in the licensee (or intermediate companies) on a long-term basis with a view to control or influence⁸; and
- companies with a common ultimate controller.

Implications of change for the proposed requirements for sufficiently independent directors and intervention plans

4.7. Our previously published drafting⁸ of the proposed condition relating to sufficiently independent directors might not restrict an appointee from being (or having recently been) a director or employee of:

- another company holding a significant interest in the licensee company or an intermediate holding company; or
- a company with the same ultimate controller as the licensee (as defined in the licence) that might be expected to be influenced by that ultimate controller.

Use of the new term, 'associate' of the licensee, would address these shortcomings.

4.8. The revised restriction on eligibility would still be subject to the exceptions set out in paragraph 4 of the draft condition. A full copy of the updated draft condition (electricity distribution version) is shown at Appendix 2.

4.9. Use of the 'associate' term in the criteria relating to intervention plans (see illustrative drafting extract 7 in Appendix 1) would mean that information would also need to be held in respect of arrangements with the parties referred to in paragraph 4.6 that relate to:

- operational control over network assets; and
- contractual rights or obligations to receive or deliver cash or other financial assets.

⁷ <http://www.legislation.gov.uk/ukpga/2000/8/section/421A> - a holding of 20% or more of the shares of an undertaking is presumed to be a participating interest unless the contrary is shown

⁸ See Appendices to associated document 'd'

Implications for restriction of indebtedness condition

4.10. The existing references to 'affiliates' and 'related undertakings' in the existing restriction of indebtedness conditions are not effective in relation to all of the parties referred to at paragraphs 4.6 above. We now consider that our proposed modifications to these condition should include a replacement of these terms with 'associate', as defined in paragraph 4.5 above so that the conditions continue to achieve the purposes set out in paragraphs 3.43 and 3.44 of our March 2011 consultation document (see associate document 'b').

4.11. It is relevant to note that:

- the restrictions, including those under the cash lock up provisions, do not affect most types of normal business transaction; and
- the consent mechanisms relating to restrictions in the conditions are unaffected by our proposed drafting changes.

Feedback sought

4.12. We believe that the introduction of a new term, 'associate' (as defined in paragraph 4.5 above) for the three licence conditions referred to in this chapter would be in keeping with the objectives we have set out for our review of the regulatory ring fence. We also consider that the impact on licensees and other stakeholders should be relatively small and is justified.

4.13. We appreciate, however, that licensees and other stakeholders will wish to consider the proposed changes in relation to their particular circumstances and we would therefore welcome responses by the deadline date of 30 November 2012. We will consider all responses received before deciding on our formal modification proposals which we now expect to publish in December 2012.

5. Impacts/costs/benefits and next steps

Impacts costs and benefits

5.1. We consider that the views on impacts set out in our previous consultation publications remain valid for our proposals including the changes discussed in this document. Whilst we will consider any comments or representations made in relation to impacts by the deadline date for this consultation, we are particularly interested to hear views on the changes we have made to proposed licence modifications which are described in this document.

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

Treatment of costs

5.3. One respondent to our July 2012 position paper consultation, whilst acknowledging that the costs of complying with the proposed ring fence modifications should be relatively immaterial, commented that costs incurred should be reimbursed through the annual iteration process for the RIIO price control financial models or included in a price control uncertainty mechanism.

5.4. We have indicated that we consider that licensees should be able to log up the efficient costs of compliance for reimbursement (on a net present value neutral basis) at the next price control settlement. However, this aspect does not form part of the proposed licence modifications and will be considered as part of relevant price control review programmes. We will therefore keep this aspect under review.

Next steps

5.5. We will carefully consider any responses to this document received by the deadline date of 30 November 2012.

5.6. We expect to issue statutory notices relating to proposed licence modifications in December 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.

5.7. 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.

5.8. 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.

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

Appendices

Index

Appendix	Name of Appendix	Page Number
1	Drafting extracts illustrating updated proposals	25
2	Updated draft condition relating to sufficiently independent directors (electricity distribution version)	28
3	Glossary	31
4	Feedback questionnaire	33

Appendix 1 – Drafting extracts illustrating updated proposals

1.1. The extracts below illustrate the changes to proposals referred to in this document, using the **Electricity Distribution Licence** as an example except where stated otherwise in the extract title. Underlying (black) text shows the drafting proposed in our July 2012 Position Paper, and the mark up (additions in red and deletions in dark red/strikethrough) shows *subsequent revisions* to our proposals.

Extract 1: Disposal of assets condition

~~26.5—In considering any Notice given by the licensee under paragraph 26.4(b)(i), the Authority shall not unreasonably withhold its consent to the transaction in question.~~

Extract 2: Availability of resources – certificate in relation to dividends

30.11 The licensee need not give the Authority a certificate of the type referred to in paragraph 30.8 in circumstances where:

- (a) during the three months preceding the declaration or recommendation of a dividend, the making of any other form of distribution or the redemption or repurchase of share capital, it has given the Authority a certificate in the form of Certificate 1C under the requirement set out in paragraph 30.6 of this condition; and
- (b) that certificate includes an appropriate addendum using the wording given at paragraph 30.9(b) of this condition.

Extract 3: Draft direction in relation to form of ultimate controller undertaking

NOW the Authority pursuant to paragraphs 2 and 3 of SLC 6 and paragraphs 1 and 2 of SLC 31 and for the purpose of specifying the forms of undertakings for the purposes of those conditions generally **HEREBY DIRECTS** that any undertakings procured **on or after 1 April 2013** to meet the requirements of the conditions are to follow the form set out in the Schedule to this Direction (not to be taken as excluding any further terms that be necessary or amendments necessary due to the particular circumstances of a case) unless the Authority directs that a different form should be followed and/or varies or revokes this Direction, including its Schedule, in writing upon reasonable notice.

Extract 4: Credit rating of the licensee – description of issuer credit rating

- 40.2 For the purposes of paragraph 40.1, an Issuer Credit Rating is any of the following:
- (a) an issuer **credit** rating by Standard & Poor's Ratings Group or any of its subsidiaries;
 - (b) an issuer **credit** rating by Moody's Investors Services Inc or any of its subsidiaries;
 - (c) an issuer **credit senior-unsecured-debt** rating by Fitch Ratings Ltd or any of its subsidiaries;
 - (d) an issuer **credit or senior-unsecured** rating by DBRS Ratings Limited or any of its affiliates; or

Extract 5: Indebtedness [Offshore Transmission Operator – Standard Condition E10]

- 5. The circumstance described by this paragraph is that the licensee holds more than one issuer credit rating **or instrument credit rating** and one or more of the ratings so held is not investment grade.
- 6. The circumstance described by this paragraph is that any issuer credit rating, or instrument credit rating **relied upon by the licensee in respect of compliance with the requirement set out at paragraph 1(b) of standard condition E11 (Credit Rating of Licensee)**, held by the licensee is BBB- by Standard & Poor's Ratings Group or Fitch Ratings Ltd or Baa3 by Moody's Investors Service, Inc. or BBB (low) by DBRS Ratings Ltd (in the case of issuer credit ratings only) or any of its affiliates (or such higher issuer credit rating or instrument credit rating as may be specified by any of these credit rating agencies from time to time as the lowest investment grade issuer credit rating), or is an equivalent rating from another agency that has been notified to the licensee by the Authority as of comparable standing for the purposes of standard condition E11 (Credit Rating of Licensee) and:

Extract 6: Indebtedness [Electricity Distribution – Standard Condition 41]

- 41.13 **Subject to paragraph 41.14,** ~~the~~ licensee must not enter into any agreement or incur any commitment that incorporates a Cross-Default Obligation.

Extract 7: Availability of resources – intervention plan criteria

-
- (h) any arrangements under which the licensee has relinquished operational control over Relevant Assets to an ~~affiliate or related undertaking~~ Associate of the licensee;
 - (i) any contractual rights to receive cash or other financial assets from any ~~affiliate or related undertaking~~ Associate of the licensee;
 - (j) any contractual obligations to deliver cash or other financial assets to any ~~affiliate or related undertaking~~ Associate of the licensee; and.....

Appendix 2 – Updated draft condition relating to sufficiently independent directors (electricity distribution version)

Condition 43A. Requirement for Sufficiently Independent Directors

43A.1 **Subject to paragraph 43A.11, E**except and to the extent that the Authority consents otherwise, the licensee must ensure that at all times after a date which is the later of:

- (a) 1 April 2014; and
- (b) 12 months after this condition comes into effect in respect of the licensee,

it has at least two non-executive directors who meet the criteria set out in paragraphs 43A.2, 43A.3, and 43A.5 below. In this condition such directors are referred to as "sufficiently independent directors".

43A.2 A sufficiently independent director must:

- (a) be a natural person;
- (b) **in the reasonable opinion of the licensee,** have the skills, knowledge, experience, and personal qualities necessary to perform effectively as a non-executive director of the licensee; **and**
- (c) not have any executive duties within the Distribution Business.

43A.3 Except and to the extent that the Authority consents otherwise, and subject to paragraph 43A.4, a sufficiently independent director must not be, and must not have been during the 12 months before his appointment as a director of the licensee or the coming into force of this condition (whichever is the later):

- (a) an employee of the licensee; or
- (b) a director or employee of ~~any affiliate or related undertaking of the licensee~~ **an Associate** of the licensee.

43A.4. The reference to 'director' in sub-paragraph 43A.3(b) does not include appointment as a non-executive director of:

- (a) ~~an affiliate or related undertaking of the licensee~~ **an Associate of the licensee** that is the holder of a gas transporter licence or an electricity transmission or electricity distribution licence;
- (b) a wholly-owned subsidiary of the licensee that has been incorporated by it solely for the purpose of raising finance for a Permitted Purpose (as that term is defined in Standard Condition 1 (Definitions for the standard conditions)); or
- (c) a Qualifying Group Company.

- 43A.5 A sufficiently independent director must not:
- (a) have, or have had during the 12 months before his appointment as a director or the coming into force of this condition (whichever is the later), any material business relationship with the licensee or any ~~affiliate or related undertaking~~ Associate of the licensee;
 - (b) hold a remit to represent the interests of any particular shareholder or group of shareholders of the licensee or the interests of any ~~affiliate or related undertaking~~ Associate of the licensee; or
 - (c) receive remuneration from the licensee or any ~~affiliate or related undertaking~~ Associate of the licensee apart from a director's fee and reasonable expenses.
- 43A.6 For the purposes of sub-paragraphs 43A.5(a) and 43A.5(c) respectively:
- (a) the holding of a small number of shares or associated rights shall not, of itself, be considered a material business relationship; and
 - (b) the receipt or retention of any benefit accrued as a result of prior employment by or service with the licensee or any ~~affiliate or related undertaking~~ Associate of the licensee shall not be considered to be remuneration.
- 43A.7 The licensee must notify the Authority of the names of its sufficiently independent directors within 14 days of ~~the coming into force of this condition the later of the two dates referred to in paragraph 43A.1~~ and must notify the Authority within 14 days where any new directors are appointed to fulfil the obligation in paragraph 43A.11 of this condition.
- 43A.8 The terms of appointment of each sufficiently independent director must include a condition stipulating that both the licensee and the appointee will use their best endeavours to ensure that the appointee remains sufficiently independent during his term of office, having particular regard to the criteria set out in paragraphs 43A.2, 43A.3 and 43A.5.
- 43A.9 A term of appointment for a sufficiently independent director may not be for longer than eight years, but an individual may be reappointed thereafter provided that he continues to meet the criteria set out in paragraphs 43A.2, 43A.3, and 43A.5.
- 43A.10 The licensee must notify the Authority in Writing within 14 days if any sufficiently independent director is removed from office or resigns, giving reasons for the removal or (to the extent that they are known to the licensee) the resignation. For the purposes of this requirement, the reasons for a resignation may, if appropriate, be stated to be personal reasons.
- 43A.11 If at any time the licensee has fewer than two sufficiently independent directors because of a removal or resignation or other reason (including death or incapacity), the licensee must ~~take all appropriate steps within its power~~ use its best endeavours to ensure that a new director is, or new directors are appointed to fulfil the obligation in paragraph 43A.1 of this condition as soon as is reasonably practicable to bring the number of sufficiently independent directors up to at least two.

Interpretation

43A.12 In this condition:

Associate means:

- (a) an Affiliate or Related undertaking of the licensee;
- (b) an Ultimate Controller of the licensee;
- (c) a Participating Owner of the licensee; or
- (d) a Common Control Company.

Common Control Company means any company, any of whose Ultimate Controllers (applying the definition set out in standard condition 1 (Definitions for the standard conditions) but substituting that company for the licensee) is also an Ultimate Controller of the licensee.

Participating Owner - For the purposes of the definition of Associate above, a person is subject to a Participating Interest by another person (a **Participating Owner**) if:

- (a) that other person holds a Participating Interest in the person; or
- (b) the person is subject to a Participating Interest by a person who is themselves subject to a Participating Interest by that other person.

Participating Interest has the meaning given in section 421A of the Financial Services and Markets Act 2000.

Qualifying Group Company means:

- (a) an immediate parent company of the licensee that holds 100% of the shares of the licensee and no other shares except for shares in one or more wholly-owned subsidiaries, each of which is the holder of a gas transporter licence or an electricity transmission licence or an electricity distribution licence;
- (b) the parent company of a group whose other members may only include :
 - (i) a company meeting the criteria set out in sub-paragraph (a); and
 - (ii) intermediate holding companies between the parent company concerned and a company meeting the criteria set out in sub-paragraph (a) provided that such intermediate holding companies:
 - (aa) have no shareholders other than the parent company concerned or another intermediate holding company; and
 - (bb) hold no shares other than shares in a company meeting the criteria set out in sub-paragraph (a) or shares in another intermediate holding company;

and

- (c) intermediate holding companies meeting the criteria set out in sub-paragraph (b)(ii).

Appendix 3 - 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 ie companies registered at Companies House.

O

OFTO - Offshore (electricity) Transmission Operator

A person (company) holding an electricity transmission licence allowing it to own, operate and maintain one of the electricity transmission systems linking offshore wind farms to the GB mainland.

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.

Appendix 4 - 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:

- (4) Do you have any comments about the overall process, which was adopted for this consultation?
- (5) Do you have any comments about the overall tone and content of the report?
- (5) Was the report easy to read and understand, could it have been better written?
- (6) To what extent did the report's conclusions provide a balanced view?
- (7) To what extent did the report make reasoned recommendations for improvement?
- (8) Please add any further comments?

1.2. Please send your comments to:

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London
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andrew.macfaul@ofgem.gov.uk